PUBLIC COMPANIES AND THE INVESTOR

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 \mathbf{BY}

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PREFACE

The average man who from time to time invests his savings in the securities of Public Companies often lacks knowledge of the Company world and its ways, and as a result frequently makes unwise selections, for which he suffers.

Balance Sheets, Prospectuses, Security-holders' Rights, Directors' Duties, Articles of Association, etc., are subjects which every investor should know something about: yet to the uninitiated they seem difficult to understand. It has been suggested to me that, in view of the rapid growth in the capital offered for public subscription, a simple explanation of these and kindred matters, from the point of view of the investor, might be of service. And that is what I have attempted to give in this book.

Of all the subjects discussed, that of the Balance Sheet is perhaps of the greatest interest: and to it I have devoted considerable space. The Balance Sheet is the most important piece of information available to an investor in regard to his security, and it is very necessary that the investor should clearly understand the principles upon which it has been drawn up, the information it seeks to give, and the limitations to which it is subject.

In regard to new issues of securities, the Prospectus is the all-important document. I have endeavoured to

indicate to the investor what to look for in a Prospectus and how to put his finger on the weak and the strong points.

The various classes of Share and Debenture Capital are described, the rights of shareholders and the duties of Directors are discussed, and sufficient explanation is, I hope, given of how Companies are regulated and administered to enable the average investor to take an intelligent interest in the fortunes and direction of the undertakings in which his savings are embarked.

A. E. CUTFORTH

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CHAPTER I

PRELIMINARY OBSERVATIONS

In this book the author has endeavoured to describe, in general terms, and so far as possible in non-technical language, the procedure and functions of Public Limited Companies from the standpoint of the investing public.

Joint Stock Company enterprise makes demands on the services of many classes of experts. In the first place, of course, there are the Directors of public Companies, each of whom is, or should be, well versed in some aspect of the affairs of the Company in whose administration he is taking a hand. There are also the Executive officials, such, for example, as the General Manager, Departmental Managers, the Secretary, the Chief Accountant. But, in addition to the Directors and other officers, there may be connected with a public Company, in one or more stages of its existence, Solicitors, Valuers, Bankers, Promoters, Professional Accountants, Underwriters, Issuing Houses, Stockbrokers, and others.

While this book will have occasion to refer to the functions of all these classes of experts, the author does not claim that it has been written for their enlightenment. Rather is it intended for the average Investor, or, to use another expression, the ordinary man of the world. Such a man should know something of

Company procedure and Company finance; but his education in these matters is not infrequently ill-balanced, and his opportunities of adding to his knowledge in this particular direction are, as a rule, few and far between. Such knowledge as he has may possibly have been acquired painfully and at considerable cost to his pocket.

Another important class of person to whom the book may be of service is the student of economic matters who has not yet had the opportunity of acquiring any extended practical experience in the financial or business world, but who expects later on to do so, and who, one imagines, hopes to become, in time, a member of the investing public.

Enormous sums are invested each year by the general public in this country in new enterprises or in the extension of existing enterprises, and this investment in the main takes place through the medium of the Public Limited Company. It is hardly necessary to point out how important it is that the investing public should exercise judgment and discrimination in such matters. The capacity to judge soundly and to form wise opinions is in a large measure a heaven-sent gift and cannot be acquired from a study of books; but, without a certain knowledge of facts, the forming of a considered opinion is impossible. It therefore follows that the more widely spread among the investing public is the knowledge of the functions and procedure of public Companies, and the capacity to read and understand a Balance Sheet, the more effective critics will the investing public become. The greater the experience and

wisdom of the investing public in these matters the less likelihood is there of money being expended unwisely or affairs being incompetently conducted by those in charge of the enterprises owned by public Companies. And the more soundly these public Companies are developed, and the more efficiently they are conducted, the greater should be the national wealth and well-being. To this latter objective the following book hopes to contribute, indirectly, its small quota.

CHAPTER II

DEVELOPMENT OF JOINT STOCK ENTERPRISE

Although business enterprise through the medium of Joint Stock Companies was a recognized feature of commercial and economic life in this country more than a century ago, its rapid development is of comparatively recent origin. Its growth followed as a natural result of the industrialisation of England and the consequent increase in the wealth of the country during the Early Victorian era; it received a great impetus by the passing in 1862 of the Companies Act, which confirmed the principle of limiting the liability of Shareholders in Joint Stock Companies to the amount of their capital embarked or agreed to be embarked: and the gradual improvement in the earning capacity of the middle and lower classes, which the last fifty years has witnessed, has led to an enormous increase in the number of small investors, and consequently an increase in the facilities provided for the investing public.

Other factors—especially pronounced during the last twenty-five years—have had a like influence, as, for example, the growth in international trade, the development of industrialism in countries like India and Japan, and the vastly improved means of conveyance and communication, both in our own and foreign countries. All these circumstances have tended to make the various countries less self-contained, and have, in effect, made the world a smaller place. Consequently the Capitalist—be he great or small—is much less restricted than formerly in regard to the geographical area in which he can interest himself.

Again, the size of the enterprises which modern conditions demand makes the provision of adequate Capital by any one individual or by a firm difficult, if not impossible.

These developments have been followed by an increased use of the machinery devised by the business community and by the legislature in this country for the protection and the convenience of the investing public. Of this machinery the Public Limited Liability Company represents a very important part.

The Public Limited Liability Company enables the man whose savings are comparatively modest to become, in effect, a small sleeping partner in a variety of undertakings or enterprises. It permits him to choose whether he will be content to receive a comparatively small fixed return on his Capital, with good security for the maintenance of the income and the preservation of the Capital; or, whether, in the hope of a larger income return on, and appreciation in the capital value of, his investment, he is prepared to run risks both as to the maintenance of the income and the preservation of the Capital. Another choice offered him is that between capital which is permanent in form (i.e. irredeemable) or that which is repayable by the Company at a certain future date, or over a certain future period. But under each of these alternatives the Investor's possible loss is

limited to the amount of the Capital which he has embarked or has agreed to embark if called upon to do so.

Further, the existence of the Public Limited Liability Company implies a market in the shares, thus enabling the Investor to dispose of, or add to, his holding at any time, should he think it desirable. It permits the Shareholder, in conjunction with the other Shareholders, to have (by a majority vote) the decision as to how, and by whom, the affairs of the Company are to be administered, and to receive from the administrators—in other words, from the Directors-certain information at certain intervals, together with a general account of their stewardship. It provides a particularly convenient form of investment from the point of view of valuation and sale (or distribution in kind) of a person's estate on his death, or the formation of family trusts during his lifetime. And, not least, it enables the Investor to spread his risks by having a comparatively small stake in a large number of diverse businesses.

Attention is called to the expression 'Public Limited Liability Company' used several times in this chapter.

It is with this class of Company that this book is primarily concerned. It may be well, however, to bring to the notice of the reader the fact that there are various classes of Companies or Associations which are owned by a large number of Shareholders collectively. There are, for instance, Companies incorporated by Royal Charter, such as the Hudson's Bay Company and the British South Africa Company; there are also such Associations as Friendly Societies, Building Societies, and

Co-operative Societies. The functions of the latter classes of Societies are governed, in some measure, by special Acts of Parliament, and in the main such functions are strictly limited. For example, the Building Society is formed with the primary object of advancing money to its members on the security of house property, thus enabling persons to own their own houses; the Co-operative Society is formed with the object of supplying its own Shareholders with commodities such as food, articles of clothing, etc., on specially favourable terms—to be precise, the bulk of the trading profit which the Society makes is distributed among the customers in the form of a bonus in ratio to the value of the goods supplied to each.

Again, there are Limited Liability Companies which operate under special Acts of Parliament, such Companies being generally known by the term 'Statutory Companies.' These Companies mainly own Public Utility Undertakings in this country, in respect of which they are given, under their special Acts of Parliament, what amounts to a monopoly, or semi-monopoly. These Public Utility Undertakings comprise Tramways, Gas and Electric Light Undertakings, Railways, Water Supply Undertakings. In such classes of Company the investing public is largely interested.

But the vast majority of Public Limited Liability Companies consists of those which are governed by the ordinary Companies Acts and not by special Acts. It is with such class of Company that this book is primarily intended to deal, although much that will be said in regard to such Companies may, as a matter of fact, apply equally to the Statutory Companies referred to in the preceding paragraph.

Before dealing with these Companies it may be well to begin by explaining for the benefit of the uninitiated what a Company is.

It is an incorporeal body or a creation of law, in one sense merely an idea. It has no body to be kicked, no conscience to be pricked, and no soul to be damned. Yet it has an existence in law quite distinct from that of the Shareholders or Directors. A Company may be formed in which there are only two Shareholders, one of whom is a mere trustee for the other, yet the Company is an entity quite distinct from such Shareholders. A man cannot contract with himself, but he can contract with a Company, in which he owns beneficially every Share. If 'A' owns a freehold estate or any other Assets he can form a Company in which he owns every Share, and sell the Estate or Assets to the Company. Thereupon 'A' ceases to own the Estate or Assets, and these become the property of the Company. It is very important to get it well fixed in one's mind that a Company is something quite distinct from the Shareholders who compose it or the Directors who manage it. Thus if the Directors of a Company wilfully break a contract made by the Company the remedy of the other party to the contract is against the Company and not against the Directors personally.

Limited Liability Companies formed under the ordinary Companies Acts need not necessarily be what are known as 'public Companies.' They may be private Companies. Speaking in general terms, a private Company is one which restricts in some manner the transfer of its Shares from one person to another, and whose Shareholders (exclusive of Directors and employees) number less than fifty. Such Companies are relieved by the legislature of certain obligations which are incumbent upon Public Limited Liability Companies. There can obviously be no 'market' in the Shares of these Companies, and the investing public cannot therefore be said to be concerned at all widely with them.

Having regard to the above facts, private Companies, as such, do not fall to be considered in this book. But much that will be said on questions such as the various classes of Share and Debenture Capital, the form and objects of Balance Sheets, the functions of Directors and Auditors, applies to private no less than to public Companies.

From the observations made in this chapter, the reader will have obtained a general idea of the chief causes which have contributed to the growth of what is commonly referred to as Joint Stock Enterprise, and he will have been made aware of the various classes of Company and Association through the medium of which investments are made by the general public. In the next chapter will be found a brief description of the enactments or ordinances which regulate Public Limited Liability Companies formed under the ordinary Companies Acts, which class of Company, as already mentioned, forms a large proportion of the whole (measured by value and not by number), and is the one dealt with by the present work.

CHAPTER III

ORDINANCES GOVERNING THE FUNCTIONS AND PROCEDURE OF PUBLIC COMPANIES

It is appropriate here, before passing on to other matters, to make a few brief observations in regard to the ordinances which govern the functions and procedure of Public Limited Liability Companies under the Companies Acts.

(a) The most important enactment (which is, of course, common to all Companies of this class) consists of the Companies Act, 1929. This Act deals with many matters, including the following:

Constitution and incorporation of a Company.

Regulations affecting the issue and distribution of Share and Debenture Capital.

Proceedings in connection with meetings of the Shareholders.

Keeping and submission of Accounts.

Appointment, remuneration, qualifications, etc. of Directors.

Powers and duties of Auditors.

Procedure in the event of a winding up of a Company.

(b) Each Company, upon its incorporation, has to prepare and obtain the signatures of the original

Shareholders (being not less than 7) to a document which is known as the *Memorandum of Association*. This document must state:

- (1) the name of the Company.
- (2) the part of the United Kingdom where the registered Office is to be situated.
- (3) the objects of the Company.
- (4) that the liability of the members is limited.
- (5) the amount of the authorized Share Capital and its division into Shares of a fixed amount.

The Company is thenceforth bound in its actions by the terms of the Memorandum, save that by certain resolutions of its Shareholders it may subsequently amend the Memorandum in certain respects if it so desires, subject in certain cases to the consent of the Court.

(c) The Company may, on its incorporation, prepare and adopt a set of regulations suitable for its purposes, known as its Articles of Association. If it does not adopt such a set of regulations, then it is to be considered as having adopted a model set of Articles of Association which are included in one of the Schedules to the Companies Act, 1929, briefly known as 'Table A.' If it does adopt its own set of Articles, then these take the place of Table A.

The Company's Articles of Association deal with many matters of domestic procedure and working, such as: The voting rights attached to the Share Capital.

The transfer of Shares.

The forfeiture of Shares.

The increase, decrease, and sub-division of the Share Capital.

The extent to which money may be borrowed.

Meetings of Shareholders and the proceedings thereat.

The powers, duties, and remuneration of Directors.

The proceedings of Directors.

The submission of Accounts.

The Shareholders of a Company have power, by certain resolutions, to alter the provisions of the Articles of Association should they at any time desire to do so.

It must, of course, be appreciated that a Company cannot include in its Articles of Association any regulation which is contrary to the provisions, either of the Companies Acts, or of its own Memorandum of Association.

Companies have to file copies of their Memorandum and Articles of Association at Somerset House, and these can be inspected on the payment of a small fee.

Those closely connected, in the course of their ordinary duties, with public Companies—such as, for example, Directors, Secretaries, Solicitors, Auditors, Stockbrokers, Bankers—will, in a greater or lesser degree, require to be familiar with the various regulations comprised in the Companies Act and in a Company's Memorandum and Articles of Association. It is not, however, for experts such as these that this book

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has been written; and it is not therefore considered necessary to enter into these matters in further detail. Enough has, it is thought, been said to indicate to the ordinary Investor the classes and character of the ordinances or documents by which the objects and procedure of the ordinary public Company are defined and regulated.

CHAPTER IV

PUBLIC COMPANY FINANCE

The formation of a public Company entails the simultaneous subscription by Shareholders of Share Capital. But the first issue of Share Capital need not necessarily comprise more than a nominal (i.e. a very small) amount. The question of further Capital, assuming such to be required, can be dealt with later, either by the issue of further Share Capital or by other means, as referred to below.

It may be well here to explain what is meant by Share Capital.

When a Company is incorporated the Memorandum of Association states the total amount of the Share Capital and the nominal amount of each Share therein—e.g. 'The Share Capital of the Company is £100,000, divided into 100,000 Shares of £1 each.' The Share Capital may be large or small, but in the case of a public Company there must be at least seven Shares, though they may be Shares of only 15. each.

Broadly speaking, the Share Capital may be arranged in any way thought desirable, and may confer any rights desired as to sharing in profits or Assets or as to voting at General Meetings.

In order to commence business a Company must have cash or other Assets with which to trade. This is obtained either by selling its Share Capital (known as issuing the same) or by borrowing in one form or another.

The law will not now allow a new Company to sell or issue its Share Capital at a greater discount than 10 per cent.: thus, if the Company has a Share Capital divided into Shares of £1 each, it must, if it issues these for cash, obtain at least 18s. per Share, but it can issue its Share Capital for Assets other than cash—e.g. a Patent, which may or may not, be valuable; and, provided the Directors act bona fide, they can, in effect, purchase such an Asset at any price thought fit, and pay for the same in Shares.

It will thus be seen that it is in the highest degree unsafe to assume that, because the Capital of a Company has been issued to the extent of, say, £10,000, the Company must have started life with Assets worth at least £10,000 less 10 per cent., or, say, £9,000. It may have issued the whole of its Capital in payment for some Asset which has proved to be of little, if any, value.

The Issued Share Capital of a Company need not consist of the whole of what is known as the Authorized Capital.

The Authorized Share Capital is the aggregate sum which is stated in the Company's Memorandum of Association: on such Authorized Share Capital a duty at the rate of 1 per cent. is payable to the Government; and, except by a resolution of the Shareholders which is in effect an alteration in the Memorandum of Association, and the payment of further duty, the Authorized Capital cannot be increased.

Issued Share Capital need not necessarily be fully paid up: in other words, the Shareholders may pay a

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portion of the amount which they have agreed to pay for each Share, and remain liable to pay the remainder as and when the Company calls upon them to do so. In the event of a Company having *Uncalled Share Capital* going into liquidation, and the Assets being found insufficient to meet the Liabilities, the Uncalled Capital would have to be called up to meet, in whole or in part, the deficiency.

The following example illustrates the foregoing remarks:

A Company's Balance Sheet contains, in respect of its Share Capital, the following information:

| AUTHORIZED SHARE CAPITAL 100,000 Shares of £1 each | •• | | £100,000 |
|--|---------|-------|----------|
| Issued Share Capital | | | |
| 50,000 Shares of £1 each, on | which 1 | os. a | |
| Share has been called and p | oaid up | | £25,000 |

In the above illustration:

| The Authorized Share Capital is | | €,100,000 |
|------------------------------------|---|---------------|
| The Issued Share Capital is | | £50,000 |
| The Paid Up Share Capital is | | £25,000 |
| The Uncalled Share Capital is | | £25,000 |
| The Unissued Share Capital is | | £50,000 |
| The nominal value of each Share is | i | £i |
| The amount paid on each Share is | | ios. |
| The amount unpaid on each Share | | 105. |
| • | | |

It will be appreciated that the existence of Uncalled Capital forms additional security as regards a Company's

creditors. In certain undertakings when extreme financial strength is of paramount importance—as in the case of Banks and Insurance Companies—it is frequently arranged, as a matter of policy, for a large portion of the Issued Share Capital to remain uncalled, thus affording additional security for the Bank's customers who have money on Deposit and Current Accounts, or, in the case of Insurance Companies, for the policy holders.

The Capital employed by a public Company may be broadly divided into two classes—namely, Share Capital and Loan Capital.

Share Capital may take many forms, and may confer widely different rights as regards participation in profits or Assets or voting at meetings. Generally speaking, Share Capital is permanent Capital, only repayable on a liquidation of the Company.

Loan Capital, again, may take many forms, such as Debentures, Debenture Stock, Notes, Loans, etc., and it may be secured by a mortgage or charge on all or some part of the Company's Assets, or it may be unsecured.

Further funds are often provided by means of retention in the business or undertaking owned by the Company of a portion of the profits earned from time to time, instead of the whole of such profits being distributed to the Shareholders in Dividends.

Again, a certain amount of Capital is, in a number of cases, automatically provided by the use, in the business, of the funds representing the accumulated reserves in respect of depreciation of Fixed Assets, such as

Buildings, Plant, etc. This is a point which it is not appropriate to explain or elaborate at the moment; it will be found dealt with in a later part of this book.

It is now proposed to make a few observations on the various forms of Share Capital.

The term 'Ordinary Shares' is in practice occasionally used somewhat loosely. In cases of Companies whose Share Capital consists of one class only, the one word 'Shares' obviously affords a sufficient description. The words 'Ordinary Shares' are as a rule used where the Share Capital consists of more than one class. In such a case the Ordinary Shares would be that class which is entitled to the surplus remaining after satisfying the claims of the other classes of Shares. There are, however, cases where two classes of Ordinary Share Capital exist, one of which ranks in part behind the other for Dividend purposes. These two classes are usually called respectively 'Preferred Ordinary' and 'Deferred Ordinary' Shares, or, more colloquially, 'Preferred' and 'Deferred' Shares, or 'Ordinary' and 'Deferred' Shares. In cases where Preferred and Deferred Ordinary Share Capital exists, it is usual to find that there are, or that there are intended in the future to be, also one or more issues of Preference Share Capital, ranking in front of the Preferred and Deferred Ordinary Capital.

As regards *Preference Shares*, these can take many forms. In the great majority of cases the Preference Share is entitled to a fixed but limited rate of Dividend which ranks wholly in front of any Dividend on the Ordinary Share Capital.

The fixed Dividend on Preference Shares may either be 'Cumulative' or 'Non-Cumulative.' In either case, it cannot be paid unless there are available profits for the purpose; but if the Shares are Non-Cumulative and the Dividend is not capable of being paid in respect of any particular year out of available profits, such Dividend does not have to be paid retrospectively out of profits which may be earned and available in some subsequent year. In other words, each year stands by itself. But with Cumulative Preference Shares the arrears of Dividend, no matter how lengthy the period over which they may have accumulated, have to be paid out of the profits of a subsequent year or years before any distribution is made upon the Ordinary Share Capital.

As a rule Preserence Shares have a priority over Ordinary Shares in regard to Capital as well as in regard to profits. That is to say, if the Company is at any time wound up, the holders of the Preserence Shares are entitled to be repaid out of the Assets remaining after payment of the Creditors before any repayment of Capital is made to the Ordinary Shareholders. On the other hand, it is comparatively rare that Preserence Shareholders, in the event of the liquidation of a Company, are entitled to be paid anything more than the par value of their Shares, plus, in the case of Cumulative Preserence Shares, the fixed Dividend accrued up to the date of repayment.

Yet another form of preferential Share is what is known as a *Participating Preference Share*. Such Share is usually entitled to a fixed rate of Dividend in priority to the Ordinary Share Capital, and then to some further 20

participation should the profits permit. The form of this further participation varies in different cases. In some cases the further participation may not arise at all until a certain rate of Dividend has been paid on the Ordinary Share Capital, while in other cases the further participation may rank pari passu with the dividends on the Ordinary Share Capital. In some cases the further participation has a maximum upper limit, while in other cases there may be no such limit.

Other variations arise in regard to participating Preference Shares by reason of the fact that in some cases the participation may be calculated by reference to the actual Dividends distributed on the Ordinary Share Capital, while in other cases it may be calculated by reference to the profits which are available for distribution on the Ordinary Share Capital irrespective of whether such profits are in fact distributed or not.

Reference has been made in this chapter to 'profits available for Dividend' or 'profits available for distribution'; and similar expressions will be found in Appendix A. It is necessary to mention that the fact that there is a credit balance on Profit and Loss Account does not necessarily imply that such balance is 'available' for Dividend. As a rule such a balance is only available if the Directors of the Company decide that it can be utilized in payment of dividend. It may, for example, happen that a Company needs in its business the whole of its floating resources. Some of these floating resources may be represented by accumulated but undistributed profits. Clearly, in such a case, the payment of a Dividend might, or would, embarrass,

or even cripple, the Company in the carrying on of its business; and the Directors may therefore decide not to treat any portion of such balance on Profit and Loss Account as available for dividend. What the rights of the Shareholders are, and what the powers of the Directors may be in such circumstances, can only be ascertained by studying the relevant clauses in the Company's Articles of Association.

Examples illustrating various possible forms of participating Preference Shares will be found in Appendix A.

Shares can be issued at a premium—in other words, for a consideration which is more than their face value; and, as explained above, they can be issued for less than face value, although theoretically the commission or discount cannot exceed 10 per cent. of the face value without the previous sanction of the Court.

The new Companies Act makes it permissible for a Company, under certain circumstances, to issue Redeemable Preference Shares.

The important thing for an Investor to bear in mind is that the name of a Share may be very misleading, and give a very imperfect idea of the rights conferred thereby. Before making an investment the Investor should ascertain through his Stockbroker, or some other competent person, what are the rights conferred by the Share which he proposes to purchase, and what are the Assets of the Company behind such Share by means of which his Dividends are to come and his Capital to be protected. The fact that a Share is called a Share of

£1 is no evidence whatever of its value or the price that can reasonably be paid for it. A £1 Share (even a so-called Preference Share) may be worth only 1d., while a 1s. Share (even if called a Deferred Share) may be worth £100.

If more of the investing public would only understand and act on this elementary principle they would be saved much loss of money and anxiety of mind.

It may be convenient here to refer to the question of voting rights in connection with Shares.

In the case of Preference Shares which are entitled to a fixed Dividend (either Cumulative or Non-Cumulative), but to no further participation in profits, it is usual nowadays to stipulate that, so long as the fixed Dividend is being promptly paid, such Shares carry no votes. An exception to this would occur in special circumstances, which would be defined—such as, for example, a proposal to alter the rights of the Preference Shareholders, or to liquidate the Company.

In cases, however, of Preferred Ordinary Shares, and in cases of Participating Preference Shares, it is usual for such Shares to carry votes in all circumstances.

In the majority of instances where Preference Shareholders are entitled under all circumstances to votes, it is usual to find that the total votes exercisable by the Ordinary Shareholders exceed the total votes exercisable by the Preference Shareholders. In regard to the passing of resolutions on all ordinary matters, a simple numerical majority of votes exercised is sufficient. For certain special purposes, however, a simple numerical majority of votes is not sufficient.

For the sake of convenience, further information and illustrations in regard to votes of Shareholders are set out in Appendix B.

It may be appropriate to say a few words about the denomination of Shares—that is to say, the *nominal* value of each Share.

The Companies Act imposes no restriction in this connection: a Share may have a nominal value of 1s. or £100, or any other amount. From the point of view of anyone who happens to hold the whole of the issued Share Capital of a Company having, for example, a total nominal value of, say, £100,000, it is obviously immaterial whether that holding is represented by 1,000 Shares of £100 each, or by 100,000 Shares of £1 each.

In the great majority of instances the nominal value of a Share is fixed at £1, this being found in practice to be the most convenient in the case of a public Company where some of the individual holdings are quite large and others quite small. If, for example, the Capital were divided into Shares of £100 each, this would mean that no single investor could own less Capital than that having a nominal value of £100—i.e. one Share—and this might preclude certain small investors from acquiring an interest in the Company. This, in its turn, might make the 'market' in the Shares somewhat more restricted than would otherwise be the case. If, on the other hand, the Capital were divided into Shares of 15.

each, there would inevitably be a number of holdings which did not amount to £1 or a multiple of a £, and this would, or might, make for inconvenience, and would certainly entail more clerical work in connection with transfers of Shares and with Dividend distributions. In particular in regard to Dividend distributions these, in the case of shares of 1s. each, could not be at a lower rate than $8\frac{1}{3}$ per cent. (i.e. 1d. per 1s. Share) without involving fractions of 1d. in the amount of the gross Dividend—i.e. the Dividend before deduction of Income Tax. In order to avoid such fractions the Dividend would have to be $8\frac{1}{3}$ per cent., or some multiple of $8\frac{1}{3}$ per cent.

Reference is made from time to time in the financial Press to the evils—or at least to the unsatisfactory features—of what is briefly known as the 'shilling share.' One or two explanatory remarks on this matter may not, therefore, be out of place here.

Objection is not taken to shilling Shares as such. As just indicated, it is, in principle, immaterial whether a Company's Capital consists of 100,000 Shares of £1 each or 2,000,000 Shares of 1s. each. The cases in which shilling Shares are open to criticism is where they do not represent the whole of the Share Capital of the Company, but only one of two or more classes of Share Capital, and where the rights attaching to them are out of all proportion to their total nominal value. Under such circumstances the holders of the remaining class or classes of Share Capital may not fully realize the position, and may therefore be liable to be misled by comparing the total nominal amounts of each class of

Capital and assuming that these have some fairly close relation to the true values. A simple example will illustrate the principle.

Let it be assumed that the owner of a business, which is worth, say, £500,000, and is earning profits at the rate of £50,000 a year, wishes to form a Public Limited Company to acquire it, with the object of inducing the public to subscribe for a substantial portion of the Shares.

One of many alternatives would be to capitalize the Company as follows:

£200,000 in $7\frac{1}{2}$ per cent. Cumulative Preference Shares of £1 each. £300,000 in Ordinary Shares of £1 each.

£500,000

and to let the public subscribe for the whole of the Preference Share Capital and, say, £100,000 of the Ordinary Share Capital. The owner would then receive as the purchase price of his business:

| Cash | | | £200,000 (the proceeds of the |
|----------|---------|-----|-------------------------------|
| | | | Preference Shares is- |
| | | | sued to the public). |
| Cash | | | £100,000 (the proceeds of the |
| | | | Ordinary Shares is- |
| | | | sued to the public). |
| Ordinary | Shares | of | |
| the Com | pany to | the | |
| | | | £200,000 |

Total purchase price £500,000

(For the sake of simplicity, it is assumed that the Vendor pays all the formation expenses of the Company privately out of his own pocket, and that the business does not require additional working Capital.)

The foregoing would represent a fair deal as between the Vendor and the public; each class of Capital would, at the inception of the Company, be worth approximately its par value. What the value of each class would ultimately be would, of course, depend upon how the Company's business prospered. If the profits largely increased, then the probability would be that the Ordinary Shares would in due course command a more substantial premium than the Preference Shares, as, although the security for the dividend on the latter would be enhanced, the rate of the dividend could not exceed 7½ per cent. If, on the other hand, the profits declined substantially, the probability would be that the Ordinary Shares would fall to a larger discount than the Preference Shares, as the dividends on the Ordinary Shares would have to disappear altogether before the fixed rate of dividend on the Preference Shares could be reduced at all.

Let it now be assumed that the Company was capitalized in quite a different manner, namely as follows:

475,000 Ordinary Shares of £1 each ... £475,000 500,000 Deferred Shares of 1s. each ... 25,000 _______ £,500,000

and let it be assumed that the Deferred Share Capital is entitled to four-fifths of the profits available after paying a dividend at the rate of 9 per cent. on the Ordinary Share Capital.

Let it be assumed that the public subscribed for 295,000 Ordinary Shares, and were allowed to subscribe for one Deferred Share of 1s. each in respect of each three Ordinary Shares of £1 each subscribed by them, and that they did so. The position would then be as follows:

The Vendor would receive as consideration for the sale of his business to the Company:

| Cash, being proceeds of Ordinary Shares sub- | |
|--|----------|
| scribed by the public | £295,000 |
| Cash, being proceeds of 98,333 Deferred | |
| Shares of 1s. each subscribed by the public | 4,916 |
| Ordinary Shares to the nominal value of | 180,000 |
| Deferred Shares not offered to the public, | |
| namely 401,667 of 1s. each | 20,084 |
| Total purchase price | £500,000 |

The position would then be that the public would hold:

| Ordinary Shares | of | the | non | ninal | |
|-----------------|----|-----|-----|-------|----------|
| value of | | | | • • | £295,000 |
| Deferred Shares | | | | | |
| value of | | | •• | | 4,916 |

Brought Forward £299,916 while the Vendor would hold:

| | the nominal | of | Shares | Ordinary |
|----------|-------------|---------------|--------|----------|
| £180,000 | | | f | value o |
| | the nominal | \mathbf{of} | Shares | Deferred |
| 20,084 | | | f | value o |

200,084 £500,000

If regard is had purely to the nominal value of the Share Capital, the Vendor's total holdings are worth in round figures two-thirds of the total holdings by the public. The real position, however, is very different, as the following calculations will show.

If the Company's profits neither contracted nor expanded, but remained at £50,000 per annum, and the whole of such profits were distributed in dividend, the position would be as follows:

| A dividend of 9 per cent. would be payable on the Ordinary Share Capital | |
|--|---------|
| of £475,000, absorbing | £42,750 |
| The balance of profits would be divi- | |
| sible as follows: | |
| $\frac{1}{8}$ to the Ordinary Shareholders £1,450 |) |
| to the Deferred Shareholders 5,800 |) |
| an annual de la companya de la comp | 7,250 |
| Total assumed dividend distribution | £50,000 |

| PUBLIC COMPANY FINANCE | 29 |
|--|---------|
| The total dividend on the Ordinary Share Capital would therefore | |
| amount to and the total dividend on the Deferred | £44,200 |
| Share Capital would amount to | 5,800 |
| Total dividend | £50,000 |
| The public, on their holding of Ordinary Share Capital of £295,000, would receive | 1,141 |
| The total dividend received by the public would therefore be | £28,592 |
| The Vendor, on his holding of Ordinary Share Capital of £180,000, would receive and on his holding of Deferred Share Capital of £20,084 he would receive | £16,749 |
| The total dividends received by the Vendor would therefore be | £21,408 |

It will therefore be seen that, although the total nominal values of the holdings of the public and the Vendor respectively are in the approximate ratios of $\frac{3}{6}$ and $\frac{3}{6}$, the Vendor receives, on the basis of total distributable profits of £50,000, something appreciably more than $\frac{2}{6}$ of such profits.

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The foregoing illustration does not, however, give sufficient indication of the inequity of the arrangement. The Deferred Shares have a very considerable speculative value, because, should the profits increase at all substantially, a very large proportion of the increase would go to them in the form of dividend.

Let it be assumed that in the course of a few years the annual profits were to increase to £70,000. In such an event, and assuming that the whole were distributed in dividend, the position would be as follows:

| Assumed profits available for dividend | £70,000 |
|--|---------|
| Amount required to pay a dividend of 9 per cent. on the Ordinary Share Capital of £475,000 | £42,750 |
| ************************************** | £27,250 |
| | £70,000 |
| In all, therefore, the Ordinary Share- | |
| holders would receive in dividend While the Deferred Shareholders would | £48,200 |
| receive in dividend | 21,800 |
| Total assumed dividends | £70,000 |

| PUBLIC COMPANY FINANCE | 31 |
|---|---------|
| The public, on their holding of Ordinary Share Capital of £295,000, | |
| would receive | £29,935 |
| And, on their holding of Deferred Capi- | • |
| tal of £4,916, they would receive \dots | 4,287 |
| The total dividends received by the public would therefore be | £34,222 |
| The Vendor, on his holding of Ordinary Share Capital of £180,000, would receive | £18,265 |
| And, on his holding of Deferred Share | |
| Capital of £20,084, he would re- | |
| ceive | I |

It will, therefore, be seen that, if the annual profits reached £70,000, more than half of them would go to the Vendor in dividends on his holdings, in spite of the fact that the nominal value of such holdings, as compared with the holdings in the hands of the public, was only as two is to three. Obviously a basis of capitalization which could lead to such a result is inequitable.

£35,778

The total dividends received by the

Vendor would therefore be

It is, of course, right to bear in mind that if the profits of the Company were to fall substantially below £50,000 the Vendor might suffer somewhat, relatively to the public. He would not, however, suffer to anything like the same extent as that to which he would benefit if profits rose.

If, for example, the profits fell by £20,000 instead of rising by £20,000—in other words, if, instead of being £50,000 they were £30,000—the position would be as follows:

There would be no dividend on the Deferred Shares, as the profits would fall short of 9 per cent. on the Ordinary Share Capital of £475,000—namely £42,750. Therefore the public and the Vendor would participate in the profits in the ratios in which they held the Ordinary Share Capital.

It will be remembered that

the vendor holds .. £180,000 of Ordinary Share Capital and the public hold £295,000 of Ordinary Share Capital making a total Or-

These ratios, it will be noted, are not very far removed from those of two to three.

Summarizing the whole position, therefore, the Vendor stands to gain very considerably if profits expand, and loses comparatively little if profits contract. And, unless the position is analyzed, the members of the investing public, at the time when the Prospectus making the offer of Ordinary and Deferred Shares was issued, might not fully appreciate how matters stood, but might jump to the conclusion that, as the Vendor was to hold in all Share Capital having a total nominal value of about two-thirds of the nominal value of the Share Capital offered for public subscription, the real values were in corresponding ratio.

Another objection to 1s. Shares is that they facilitate the divorce of the voting control of a Company from the financial interest. Let it be assumed that a Company is capitalized as follows:

| 100,000 6 per cent. Cumulative Preference | |
|---|----------|
| Shares of £1 each | £100,000 |
| 100,000 Ordinary Shares of £1 each | 100,000 |
| 300,000 Deferred Shares of 1s. each | 15,000 |

£215,000

If the Articles of Association provide that each Share shall confer one vote, the individual (say, for example, the promoter) holding only £15,000 of investment in the Company (i.e. the shilling shares) can override the wishes of the public, who have £200,000 at stake.

Yet another objection which may, in certain cases, be urged against the 'shilling share' is that it is apt to create the illusion of cheapness on the market.

For example, if a Company's net Assets were worth £1,000,000, and the Company was capitalized as follows:

£400,000 in $7\frac{1}{2}$ per cent. Cum. Preference Shares £600,000 in Ordinary Shares,

the Share Capital of either class should be worth on the market about par. The Ordinary Share Capital might consist of 600,000 Shares of £1 each, or it might conceivably consist of 12,000,000 Shares of 1s. each. In the latter event each Share should still be worth, on

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the market, its par value—namely 15. But the very fact that the value was so low might create, in the mind of an indiscriminating investor, the idea that the Share was priced cheaply, and might induce him to purchase a holding.

As regards Debenture Capital, the expression 'Debenture' is used here to denote a public issue of Debentures or Debenture Stock. Strictly speaking, the term 'Debenture' merely means an acknowledgment of indebtedness, and does not imply any Mortgage or charge on assets. In practice, however, the expression is used to mean either that there is a specific charge on certain assets or a floating charge on the assets generally.

Obviously there can be very many classes of Debenture, that is to say as regards its terms. For example, a Debenture may be permanent (except in circumstances such as the liquidation of the Company); that is to say, neither the Debenture holder nor the Company has the right to have the Debenture paid off. Or, a Debenture may be redeemable. The redemption may either be effected over a certain period or at the end of a certain period. Yet again, the terms of the Debenture may provide that, at the end of the period named, the Company may effect redemption if it chooses, or, alternatively, the stipulation may be that the Company must effect redemption.

Again, redemption may take place at par or at a premium; incidental to this it may be mentioned that a Debenture may be issued, if the Company so

desires, at a price less than par, and this is a point to be remembered by an Investor.

In cases where Debentures are redeemable, either over a period or at a certain fixed future date, it is not unusual to provide for this purpose a sinking fund—that is to say, to stipulate that an amount is to be set aside out of each year's profits and applied either directly or indirectly in liquidation of the Debenture debt. The question of sinking funds will be found referred to in a certain amount of detail later on in this book—namely in Chapter VII.

Debenture holders, as a rule, have no voting rights. So long as their security from a Capital point of view and from the point of view of the prompt payment of interest is not in danger, they have, as a rule, to remain passive. If, however, they can show, to the satisfaction of the Court, that their security from the Capital point of view is in danger, they may become entitled to appoint a Receiver—that is to say, an individual who will take control of the assets which form the specific security for the Debenture holders and deal with such assets (as, for example, by sale) in the best interests of the Debenture holders.

It may be stated in a broad sense that Dividends on Share Capital can only be paid out of profits, but interest on Debenture Capital is payable irrespective of whether profits are earned or not; and in cases where the Deeds securing the Debentures stipulate for a sinking fund to be accumulated out of profits, the sinking fund charge operates, as a rule, in priority to any Dividend distributions to Shareholders.

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Occasionally Debentures are issued on the terms that the holders can, if they think fit, exchange their Debentures for Shares, either on a certain future date or within a certain future period. Such an arrangement, however, is not a very common one. Its object, of course, is to make the Debenture issue more attractive to the investor by giving him an option to become a Shareholder, which option, if the business prospers, would be a valuable one.

From what has been said above in regard to Share Capital and Debenture Capital, the reader will probably have appreciated something of the relative advantages and disadvantages from the investor's point of view of each of these classes of Capital. He will also have obtained some understanding of the merits and demerits from the point of view of the Company itself.

From the investor's point of view, the advantages of holding Debentures as compared with those of holding Shares may be summarized as follows:

- (1) Better security from the point of view of preservation of the Capital value, as Debenture Capital ranks in priority to Share Capital on a liquidation.
- (2) Better security for the maintenance of the Income, as Debenture Interest is payable no matter whether profits are earned or not, and it ranks, of course, in priority to Dividend distributions on Share Capital.
- (3) An automatic improvement in security, both from a Capital and also an Income point of view, in cases where a sinking fund, accumulated by annual charges

- to Profit and Loss Account, has been set up for the redemption of the Debentures.
- (4) The right (in certain cases) to have the Capital repaid, either at a fixed future date or over a fixed future period.

On the other hand, the usual advantages of a holding in Share Capital as distinct from Debenture Capital, from the point of view of the investor, are, briefly, as follows:

- (1) A higher income yield on the purchase price of the security.
- (2) No upper limit to the possible future Income yield. (This does not apply, of course, to Non-Participating Preference Shares.)
- (3) No upper limit to the amount which may be repayable in the event of the liquidation of the Company. (This does not, as a rule, apply to Preference Shares.)
- (4) Voting rights—affording some measure of control over the affairs and administration of the Company.

From the point of view of the Company itself, the question of the advantages or disadvantages of Debenture Capital may depend to a considerable degree upon the nature of the business and of the assets employed therein.

In an ordinary case, a Company can, of course, raise money on Debentures on better terms than by means of an issue of Preference Shares or Ordinary Shares. In other words, the Investor in the Debentures is content, as already explained, with a smaller Income yield than the Investor in Preference or Ordinary Shares, because

the security for the maintenance of that Income is better in the one case than in the other. On the other hand, the terms on which a Company can issue Debentures depend to no small extent upon the nature of the business and the character of the assets. As a general rule, the Company whose circumstances best fit it to raise money on Debentures is a Company which owns fixed assets which have a definite and considerable value irrespective of whether the Company's business, which is carried on by the use of them, is successful or the reverse. In many cases Land and Buildings fall under this category: but in other cases their value may largely depend upon the success of the particular business in which they are being utilized. The Debentures can be given what is known as a fixed charge (i.e. a mortgage) on such assets, and this fixed charge puts the Debenture holders, relatively speaking, in a strong position in the event of the Company's business falling upon evil days.

It must, of course, be appreciated that a Company cannot raise the whole (or, in the large majority of cases, the greater part) of its Capital in the form of Debentures. The creation of Debenture Capital presupposes, in an ordinary case, that there is 'cover' as regards assets; in other words, that the total assets of the business, less the trade liabilities, exceed in value the amount of the Debenture Capital. It is usual to find that the Share Capital of a Company in total largely exceeds the Debenture Capital. From a Company's point of view, therefore, the choice does not lie between Debenture Capital on the one hand and Share Capital

on the other, but between Debenture Capital plus Share Capital on the one hand, and Share Capital alone on the other.

One possible disadvantage of Debenture Capital is that its existence may have a prejudicial effect upon a Company's credit for ordinary trade purposes. And, further, the existence of a Debenture debt materially affects the extent to which a Company, when temporarily short of floating Capital, is in a position to borrow money from its Bankers.

Another possible disadvantage of Debenture Capital is that, when a Company is carrying on its business at a loss, interest on the Debenture debt has still to be paid; whereas, if profits are not available, Dividends cannot be distributed on Share Capital. A Company which is making a trading loss is, in effect, using up its floating Capital to the extent of the loss, and this is a process which cannot continue indefinitely without bringing the Company to grief. If, in addition to the shrinkage in the assets owing to the trading loss, there is an annual disbursement in respect of Debenture Interest (and possibly also the provision in respect of a Debenture sinking fund which may require to be invested outside the business or utilized to redeem the Debentures) the unsatisfactory position from the point of view of the reduction of liquid resources is accentuated: and when the Debenture holders' security becomes enforceable, the Debenture holders, through the medium of a Receiver, may step in and take control of the business. In such a case the assets may be disposed of on the basis of a forced realization in order to satisfy

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the Debenture debt, and little or nothing may remain for the Shareholders.

A Company having Debenture Capital cannot—all other things being equal—issue Preference or Ordinary Share Capital on quite such favourable terms as would be the case were no Debenture Capital in existence. On the other hand, of course, a Company which chooses to issue Capital in more than one form has an advantage in that it is able to appeal to more than one class of Investor. Certain Investors are content with a relatively small return on their money so long as they think that the security for the maintenance of the Income is very good; and to such Investors Debentures make a special appeal. Other Investors are willing to accept a somewhat greater measure of risk as regards the continuation of the Income on their investments, and as consideration they expect a correspondingly high yield. To these Investors, Preference Shares may be attractive. Yet again, other Investors are prepared to run a not inconsiderable risk in regard to Income yield, accompanied with an actual or anticipated higher return on their money, and possibility of Capital appreciation, and for them the Ordinary Share, with its greater element of speculation, may be more suitable.

A possible advantage of a Debenture issue as compared with an issue of Shares is that, if the Company in question finds itself possessed, either temporarily or permanently, of somewhat more floating Capital than it requires, it can purchase its own Debentures in the market and either hold them as investments or cancel them. If it does not cancel them it can, if it needs

more floating Capital at some subsequent date, sell them for cash. It is, however, illegal for a Company to purchase its own shares.

While dealing with the subject of Debenture Capital it may be well to mention that it is a common practice in the case of Debenture issues to appoint one or more individuals or corporations as Debenture Trustees. It is usually the duty of these parties to take under their control the documents of title to any assets specifically pledged as security for the Debentures, and generally to hold a watching brief on behalf of the Debenture holders with the object of seeing that the provisions of the Debenture Trust Deed are complied with. to the Debenture Trust Deed itself the Trustees are parties as representing the Debenture holders, the other party being the Company through the medium of the Directors. For the duties which they carry out and the responsibilities which they assume the Trustees receive an annual fee which is payable by the Company, the amount of such fee being stated in the Debenture Trust Deed.

Before leaving the question of Share and Debenture Capital, reference should be made to Appendix C., in which an example of unwise capitalization is set out and commented upon.

Having dealt with the two chief forms which the Capital of a public Company takes, namely Share Capital and Debenture Capital, and which is provided in the great majority of cases by the investing public, it is now appropriate to refer briefly to the other sources, which are mentioned at the beginning of this chapter, from which funds may be derived.

It is by no means uncommon for Public Limited Companies to finance their businesses in part by means of loans from Bankers or other financial institutions, or by taking money on deposit. Such loans may either be specifically secured or, if the financial strength of the Company is very great, the Lenders may be agreeable to dispense with the pledging of specific assets as security for the advances. It is not the ordinary function of a Banker to grant long-term loans; and in a large proportion of the cases where Bankers lend money to public Companies the loans represent temporary financing pending the issue to the public, at the next convenient opportunity, of further Share or Debenture Capital, out of the proceeds of which the loans are to be repaid. Such financing may be required owing, for example, to the growth of a business necessitating the provision of further floating Capital, or, alternatively, to the floating Capital being drawn upon to meet expenditure on additions to fixed assets, such as Land, Buildings, and Plant. It would, or might be, inconvenient for the Company to be making small public issues of Debentures or Shares at frequent intervals; in consequence the Bankers are asked to provide the necessary facilities temporarily.

Another means of repaying Bank loans is by retaining in the business a portion of the profits earned instead of distributing such profits wholly in dividend. By this means the floating Capital gradually increases and the Bank loans can be reduced.

But Bank loans may not solely be required as a result of the gradual expansion in the necessary floating Capital required by a Company, or to meet expenditure on additions to fixed assets. In some classes of business there is a seasonal trade which necessitates a much greater quantity of floating Capital being available at a certain time or times in each year than at other times. For example, a Cotton Plantation Company may be spending money throughout the year on the upkeep of its Plantations and the picking and transporting of the cotton; and just at the beginning of the period in each year when it commences to sell the crop its requirements as regards liquid resources are at the peak. As soon as the proceeds of the sale of the crop begin to come to hand the necessary floating Capital required for the business rapidly falls. It might clearly be disadvantageous to such a Company were it to raise, by the issue of Shares or Debentures, sufficient money to furnish its business with adequate floating Capital at the peak period; such an arrangement might mean that for a large part of each year a considerable amount of Capital would be idle—in other words, it would be represented by cash on deposit with Bankers, which would be earning a relatively low return in the shape of interest. In such a business the usual course is to borrow money from Banks and other financial houses to assist in financing the temporary requirements. The lender of the money may hold as security, where possible and convenient, the documents of title to the commodity, and may collect in due course the proceeds of the sale and apply them in extinction of the advance. Or the

lenders may be willing to advance the money for such purposes, within strict limits, without specific security.

As the reader is no doubt aware, the rates of interest charged by Bankers and Finance Houses in this country for temporary accommodation are, as a rule, regulated by the Bank Rate for the time being. The expression 'Bank Rate' means, in effect, the rate of interest at which the Bank of England will lend money on firstclass security. The Bank Rate depends upon the demand for, and the supply of, money from time to time; and this, in its turn, may depend on many things, such as the state of trade, the volume and prices of the world's harvests, the activities of the Stock Exchanges, international relationships.

It sometimes happens that for many months the Bank of England rate may remain at a low figure, and consequently the rates of interest charged by Banks generally in this country for loans would remain relatively low. To the uninitiated this may appear an excellent reason why a Limited Liability Company having good credit should endeavour to finance its requirements, to the uttermost that its Bankers will allow, by means of Bank loans, rather than to raise permanent Capital by, for example, an issue of Preference Shares on which it may have to agree to pay a fixed dividend at the rate of say 6 per cent. or 7 per cent. per annum. It is, however, necessary to bear in mind the very important point that in regard to a Bank loan the Banker has an option as to the time of repayment. In other words, while the Company having a Bank loan can, of course, repay it at any time that it is

able and chooses to do so, the Bank can equally call for repayment at any time. In the case of Share Capital, however-and equally in the case of Debenture Capital -no such option on the part of the provider of the money exists. And, further, it must be remembered that it is when financial and commercial conditions are such that there is plenty of money available to be lent-in other words, when the supply of money exceeds the demand—that the Bank Rate is low. Conversely, when there is a shortage of money available for lending—that is to say, when the demand for loans exceeds the supply—the Bank Rate is high. In times of political uncertainty or during financial crises, there is a marked tendency on the part of lenders of money to restrict credit; and it may well be the case that a Company which has obtained considerable facilities from its Bankers at a time when the general commercial and financial situation is good, is faced, when times are bad, with an increase in the rate of interest charged on the loan, and possibly also with a request from the Bankers that the loan may be reduced—or, at least, with a refusal by the Bankers to lend further monies. And it may be precisely at such a time that the Company needs further facilities, and, owing to Stock Exchange and money market conditions, it is impracticable, for the time being, to raise the necessary funds by means of a public issue of Shares or Debentures. The Bankers cannot in such an event be criticized; it is the Company which has been unwise in its policy of financing its business in making too great a use of Bankers' facilities.

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Enough has been said for the reader to appreciate that, in regard to temporary financing by means of loans from Bankers or other parties, there is no fixed rule which can be applied to all cases, but that in each case where such financing is warranted there is a happy mean which avoids, on the one hand, the retention by a Company, over a long period, of floating Capital altogether surplus to its actual or anticipated requirements, but which, on the other hand, assures that the Company will not have placed itself, by a too liberal use of temporary financing, in a position which, in times of financial stringency, may seriously cripple its business by denuding it of necessary liquid resources.

As a general rule it is dangerous for a Trading Company to take much money on deposit. Such deposits are usually payable at very short notice, and it frequently happens that they are called in just when it is inconvenient to pay them.

It was mentioned at the beginning of this chapter that, in addition to funds raised by Shares, Debentures, and Loans, funds may also be provided in a number of cases by profits being retained in the business instead of being distributed in dividend, and also by the funds representing accumulated reserves for depreciation. It is not necessary to make further observations here on these classes of Capital; comment on them will be found in Chapter VII (which deals with the Balance Sheet of a public Company), and general information incidental to this matter is included in certain of the Appendices.

From the point of view of the Company as an entity, this is by far the best way of providing money. No interest has to be paid, no redemption is required, and the existence of undivided profits in a business makes it comparatively easy to raise any other kind of Capital desired.

A question which frequently arises for the consideration of a Board of Directors of a public Company is that of the extent to which the Company should retain the annual profits instead of distributing them to its Shareholders in dividend. This is a question to which no general answer can be given; everything depends on the circumstances of each case.

One of the first points to consider is whether the Company's business needs, or is likely in the near future to need, the resources in question; and if the answer is in the affirmative the question for consideration is whether it is preferable to obtain the resources by making an issue of Share or Debenture Capital—thus freeing an equivalent amount of undivided profits for dividend purposes—or whether it would be in the best interests of the Company's Shareholders to restrict the amount of the dividend, thus rendering the funds representing certain of the accumulated profits available for the needs of the Company's business.

If, on the other hand, the business is equipped with ample resources to meet its existing and any anticipated possible future needs, there are obviously limits beyond which a conservative policy of retaining profits in the Company instead of distributing them in dividend to the Shareholders should not go. Such a policy, if

carried to extremes, would only result in the Company gradually accumulating a number of Stock Exchange securities, the income received from which would either be applied to purchase still more securities or would be distributed to the Shareholders of the Company in dividend. In course of time, therefore, the Company might, to a considerable extent, be assuming the functions of an Investment Trust Company, which functions might, it is presumed, be very different from those which the Company was formed to exercise. And the Shareholders might well prefer, in such a case, to receive the whole, or substantially the whole, of the profits of the Company in dividend rather than that the Company should retain a large portion of them. In brief, the Shareholders might prefer to receive the money and invest it themselves—in which event they would in due course receive the whole of the dividends paid annually on such investments—rather than that the Company should do the investing on behalf of the Shareholders collectively, and possibly retain some portion of the income arising from such investments instead of distributing it wholly in dividend.

The question of profits earned and profits distributed in dividend will be found referred to later in the illustrations given in Appendix I.

It is possible that the reader may not have appreciated the exact meaning to be attached to various expressions made use of in this chapter, such as, for example, 'Fixed Capital,' 'Floating Capital,' 'Permanent Capital,' 'Temporary Capital,' 'Capital employed in the business.' With this and other objects in

view, a pro forma Balance Sheet and comments thereon will be found in Appendix D illustrating various points referred to herein.

While dealing with the question of Public Company finance, it is appropriate to say something in regard to the issue of Bonus Shares, and also in regard to the expression 'Watered Capital,' of which so much is at times heard.

The expression 'Watered Capital' means, broadly, that by a manipulation of figures, which, from the legal point of view, cannot be attacked, a Balance Sheet is submitted giving an exaggerated idea of the value of a Company's Assets, as, for example, by assets being brought into the Balance Sheet at figures in excess of their true worth.

It will be realized, of course, that there are many Balance Sheets in which assets appear at figures much in excess of the current value of such assets, but where no specific watering of Capital has taken place. For example, a Company may have purchased a business from an individual, and to that business a valuable goodwill may, at that time, have attached. The Company may have paid a fair value for the goodwill, and at such value the goodwill would appear as an asset in its Balance Sheet. Subsequently the earning capacity of the business may have declined, and in consequence the value of the goodwill may have evaporated, although the item might still appear in the Company's Balance Sheet at what the Company paid for it.

If, however, the circumstances had been different, E1

and, at the time when the Company acquired the business there was not, in fact, any value in the goodwill, but if, notwithstanding this, the Company paid a sum for the business which could only be justified on the assumption that there was at that time a value in the goodwill, then the Company's Capital (which would, of course, correspond with the purchase price of the business) could be described as 'watered.'

Examples of watered Capital are not infrequently found in cases where temporary booms occur in certain trades. Some of the far-sighted owners of such businesses sell their undertakings either to the public or to their competitors at prices which are founded on this temporary prosperity, and which are therefore inflated. Not infrequently it happens that financial agents (not of high class) arrange for quite a number of these businesses to be sold to the public under the guise of an amalgamation, the public being induced to pay an altogether excessive price, partly by reason of the good profit-showing of the previous few years-which, as indicated above, may be transitory only-and partly by expectations as to economies which the promoters suggest will automatically result from the amalgamation of the businesses. Consequently the Share Capital of the new Company owning the combined businesses appears at too high a figure, as the assets which it represents are over-valued. When the wave of abnormal prosperity has passed, the 'water' in the Balance Sheet becomes only too apparent, as the net profits are insufficient to pay a reasonable return, in the form of dividend, on the issued Share Capital.

In the minds of many of the public, there is a close connection—usually a mistaken one—between the watering of Share Capital and the issuing of Bonus Shares. It may be that, in certain cases, the issue of Bonus Shares denotes a watering of Share Capital; in the great majority of instances, however, this is not so, and the usual effect of the issue of the Bonus Shares is to improve the Balance Sheet from the point of view of making it indicate the true position, and not to make it misleading.

In a proper case, Bonus Shares are issued out of reserves which a Company has accumulated by leaving in its business each year a portion of the profits earned instead of distributing the whole of such profits in the form of Dividend. These reserves are represented by assets of equivalent value; such assets are presumably needed for the carrying on, or the development, of the business, and in effect they represent Capital employed no less than does the permanent Share Capital. The natural effect of accumulating this profit in the business is that the nominal issued Share Capital gradually becomes of greater value. In other words, the real value of the Share Capital exceeds, by a greater sum each year, the par or nominal value at which it appears in the Balance Sheet. For example, a Company may have commenced operations with a Capital of £100,000 and be at that time earning net profits at the rate of, say, £,10,000 a year. The business of that Company may have expanded, and such expansion has necessitated the gradual provision of additional Capital. The Directors are faced with two alternatives, one being to

distribute the whole, or substantially the whole, of the profits in Dividend each year, and then, from time to time, to ask the Shareholders or the public generally to subscribe for additional Share Capital for cash, or they may pursue the alternative policy of paying a very moderate Dividend, of retaining a considerable portion of each year's profits in the business, and so, automatically, providing the necessary additional Floating Capital.

Under the first alternative the position at the end of, say, ten years might be as follows:

| Further Sl subscribe | hare Capi ed for by | ital th e | £100,000 | Assets neces business | | £150,000 |
|-------------------------|------------------------|-------------------------|----------|--------------------------|--|----------|
| public f | rom time | to | | | | |
| time | • • | • • | 50,000 | | | |
| | | | £150,000 | | | £150,000 |

Under the second alternative the position at the end of the ten years would be:

| Original issued Share Capital General Reserve Account | £100,000 | Assets necessary for business | |
|---|----------|-------------------------------|----------|
| | £150,000 | | £150,000 |

If the Directors adopted the second alternative, they might quite properly come to the conclusion at the end of the tenth year that the circumstances warranted their making a Bonus issue to the Shareholders. They might then obtain the Shareholders' sanction to distribute, as a bonus, one share of \mathcal{L}_{I} each for every two shares of \mathcal{L}_{I} each of the original Capital. When this has been done the Balance Sheet would appear thus:

Share Capital . . . £150,000 Assets necessary for the business . . £150,000
$$\underbrace{ \text{£150,000}}_{\text{£150,000}}$$

The same result, therefore, would have been achieved in the end as was achieved under the first alternative by the distribution of the whole of the profits in Dividends, and the issue from time to time of additional Share Capital for cash.

An issue of Bonus Shares may, however, under certain circumstances, constitute a watering of Capital. For example, the financial position of a Limited Company may be summarized thus:

Let it be assumed that the normal Profits of this Company are at the rate of £10,000 a year, and that on this basis the Share Capital is worth par. Let it be supposed, however, that the suggestion was made that the Company's prospects warranted a higher capitalization, and, as a result, the Directors, with the approval of the Shareholders, carried through a recapitalization

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scheme by selling the business of the Company to a new Company specially formed to acquire it, and fixing the purchase price at £200,000, to be paid for in Shares of the new Company taken at par. The position would be that the old Company would sell its business, and, instead of owning various classes of Assets of the real value, in total, of £,100,000, it would hold Shares in the new Company of a nominal value of £200,000. It would then go into liquidation and would distribute these Shares among its own Shareholders. Each of these latter would, therefore, receive two Shares in the new Company for every one Share he originally held. Of his new holding 50 per cent. would therefore, in effect, constitute a bonus. If the beliefs held out as to the future prosperity of the business were justified, each of the Shares in the new Company would be worth par and the bonus would be a real one. If, however, at the time when the reconstruction took place, the real value of the business was only £,100,000, it is clear that the real value of the 200,000 f, I shares in the new Company can only be £100,000, that is to say that each £1 share would only be worth 10s. In other words, the new Company would be over-capitalized, or, to use the alternative expression, its capital would contain 'water.'

CHAPTER V

PUBLIC COMPANY ADMINISTRATION

The administration of a Public Limited Liability Company is in the hands of a Board of Directors, the members of which are usually appointed by the Shareholders, but there is nothing in the Companies Act which requires that this power should be vested in the Shareholders. Sometimes Articles of Association give Debenture holders the right to appoint some or all of the Directors, and theoretically the power of appointing the Directors can be vested in some person or body having no financial stake in the Company at all. In the main, the regulations affecting the Directors of a Company are to be found in the Company's Articles of Association. Such Articles would, or might, include the following:

The minimum number of Shares in the Company which a Director must own in order to qualify him to hold that office.

The maximum and minimum number of Directors of which the Board can consist.

The amount or basis of the Directors' remuneration.

The power of the Board to appoint one or more of its members as Managing Directors, and to fix the remuneration of such Managing Directors.

The periodical automatic retirement from office of the

various members of the Board and their re-election or, alternatively, the election of Directors to take their place.

The necessary quorum at Directors' meetings, and the voting at Directors' meetings (the Companies Act requires a Minute Book to be kept recording the proceedings at Directors' Meetings).

The circumstances under which a Director is forced to vacate office—as, for example, if he is made a bankrupt, or if he becomes insane, or if he absents himself from his duties longer than a specified period.

It is hardly within the scope of this book to discuss in any detail the position of Directors from the legal point of view—e.g. as to their power to contract on a Company's behalf, their legal responsibilities, etc. It is, however, appropriate to make a few comments on the general procedure, functions, and responsibilities of Boards of Directors in actual practice, so far as Public Companies are concerned.

What is a reasonable number of Directors for a Public Company to have must obviously depend on the particular circumstances of the case, and the same remark applies to the question of the extent of the supervision which a Board of Directors exercises over a Company's affairs.

Much, of course, depends on the size and nature of the business owned by the Company. All other things being equal, a large and a complicated business would call for a larger Directorate in number than a small and relatively simple business. Here again, however, a great deal depends on the extent to which it is necessary for the Directors to consider matters of detail; and this, in its turn, depends upon the reliance that can properly be placed by the Board upon the chief officials, such as General Managers, Managers, the Secretary, and others. In other words, it is necessary to consider the administrative machinery as a whole.

In some classes of undertaking the Board of Directors is a very large one. For example, in the case of the largest English Banks the Board numbers between 30 and 40, and in the case of the chief English Railway Companies the Board numbers between 20 and 30. Some of the most important Insurance Companies have Boards of about 20 members.

In the case of large Companies owning commercial or industrial undertakings the Boards are, as a rule, considerably smaller, though, here again, instances can be cited of Boards ranging between 15 and 30 members.

Anyone with experience of Company administration knows that it is impracticable to transact business in any detail at Board Meetings at which so many as 20 or 30 members are present, or to call such meetings at very frequent intervals. But that does not necessarily constitute an objection to the existence of Boards as large as these.

In very large undertakings it is usual for much administrative business to be directed by Committees of the main Board, each Committee specializing in some particular department or section of the Company's business. The members of each Committee are relatively few in number, and the Committees meet comparatively frequently.

Arrangements would be made whereunder, in regard to certain classes of business to be transacted, a Committee could exercise full powers without seeking in advance the specific authorization of the main Board or even reporting subsequently to the main Board the action taken. In regard to other classes of transactions it might be provided that, although a Committee of the Board could act on its own authority, its action would require to be notified to the next meeting of the full Board for formal confirmation. In regard to yet other classes of transactions it might be provided that a Committee had only power to make recommendations, and that the business could not actually be transacted until it had received the approval of the Board as a whole. By the above means, frequent meetings of the full Board are avoided, and the procedure at such meetings is mainly confined to the consideration of important matters of general principle, or to the approval of action taken or recommendations made by Committees.

Again, it not infrequently happens, in Companies owning large and complicated industrial undertakings, that those in charge of the management of the various sections or departments of the business are given seats on the Board, thus becoming Managing Directors. Such an arrangement, though having the outward appearance of making the Board unwieldy by reason of its size, may have great advantages in that by making a Manager a Director his status and authority, both in the eyes of the Company's employees and also in those of persons with whom the Company does business, are enlarged. But, even assuming that a Board, though

large, contains few Managing Directors, the services of each member of the Board may yet have a considerable value to the Company by reason, it may be, of his influence, or by reason of his special knowledge of some aspect or section of the Company's business. For example, he may be specially versed in legal matters, or hemay have special experience of engineering problems, or of finance, or of the management and control of labour, or of the purchase of supplies, or of local conditions in the country where the Company operates.

Leaving out of consideration specially large and complicated businesses, and having in mind undertakings where the Boards of Directors are, in number, of normal size—say from 4 to 8 Directors—the exact functions which the Board exercises and the amount of time which its members devote to the affairs of the Company may vary widely. Much may depend upon whether there is a whole-time Managing Director; and, again, much may depend upon the status and ability of the Secretary. Some Secretaries of Public Companies exercise—with the approval of their Boards—functions more appropriate to a Managing Director; others are not fitted to do this, and their work is more strictly confined to that of a purely secretarial nature. It is obvious that in the latter case—assuming that no Managing Director exists-much more work and responsibility must devolve upon the Board of Directors as a whole, or on individual members of the Board, than in the former case.

As a general rule the Chairman of a Company devotes more time to the Company's affairs than any one

of the remaining members of the Board (unless indeed one of the latter happens to be a Managing Director); and he usually receives, in consequence of this, a higher remuneration than any of his colleagues.

The work of a Company Director may by no means be confined to that undertaken at Board Meetings; and this remark is, as a rule, particularly applicable in regard to the Chairman. Board Meetings may take place monthly or fortnightly, or even weekly, but the necessary supervision by the members of the Board over a Company's affairs may entail their attendance at the Company's offices on other occasions, in order to discuss matters with the Secretary or other officials, to give instructions, and to make decisions. Alternatively, a Director may maintain touch with the Company by correspondence with the Secretary.

The remuneration of a Director of a public Company is usually a fixed one—that is to say, it is at the rate of so much per annum. In some cases a remuneration is fixed for the Board as a whole, and it is left to the Directors to decide as to its apportionment between them.

In certain instances—comparatively rare—each Director's remuneration is fixed at a certain figure per attendance at Board Meetings.

In some cases the remuneration of the Board is not wholly fixed on the basis of so much per annum, but consists, in whole or in part, of a percentage share of the profits of the Company. Where such an arrangement is in operation, it is commonly stipulated that the percentage shall only be calculated

on profits remaining after some reasonable return has been paid, in the form of Dividend, on the Share Capital of the Company. Cases have occurred where an arrangement of this character, though equitable at the time when it was instituted, has, owing to the great development in a Company's business, had the effect of yielding to the Directors a remuneration which is altogether excessive. In such cases it is not uncommon for a revision of the arrangement to be made, whereunder either a maximum upper limit to the total remuneration has been imposed, or, alternatively, the percentage rate applied to the figure of profits has been reduced. In some such cases the revision of the arrangement has been at the instigation of the Shareholders, but in other cases the Board itself has made the first move.

In reviewing the position generally in order to form an opinion as to whether the amount of the remuneration, calculated by reference to profits, is excessive, Shareholders should take into account not only the current income which is yielded to the Directors, but also the income which those same gentlemen have received for their services in past years. Cases where Directors' remuneration consists partly of a fixed fee and partly of participation in profits occasionally arise where the fixed fee represents a quite inadequate reward for the work undertaken; and where, for many years, in spite of valuable and efficient services by the Directors, the profits have not reached the level which entitles the Directors to any share thereof. In such cases the whole period of the services should be

taken into consideration by Shareholders who seek to criticize.

While the question of the Directors' remuneration is, as already mentioned, a matter for the Shareholders, it is usual to find in a Company's Articles of Association a provision to the effect that the Directors, without reference to the Shareholders, can fix the remuneration paid to any one or more of their number who may act as Managers of the Company's business. While commenting on the question of Directors' remuneration it may be mentioned that under the Companies Act, 1929, the annual accounts of a Company have to disclose the total amount paid to Directors as remuneration (exclusive of the remuneration payable to a Director as Manager or other salaried official of the Company). It is further provided, under the same Act, that a certain proportion (in voting power) of the Shareholders can require the disclosure of the aggregate remuneration paid to the Directors in any respect whatsoever.

The Act also stipulates that the annual Accounts shall, under certain circumstances, disclose particulars in regard to loans made to Directors.

The law does not require that a Director shall be a Shareholder, but it is usual to provide in the Articles of Association of a public Company that a Director must hold a certain number of the Company's Shares—known as his 'qualification shares.' The London Stock Exchange requires that a Director of a Company whose Shares are to be officially quoted shall hold a reasonable Share qualification.

Prior to the coming into operation of the Companies Act, 1929, it was possible for a Company, by its Articles of Association, to exempt any Director, Manager, or Officer of the Company, or the Auditor, from any liability which might otherwise attach to him in respect of negligence, breach of duty, or breach of trust in relation to the Company. Such exemption is, however, now made illegal.

If any Director has a direct or indirect interest in any contract or proposed contract with the Company of which he is a Director he is required by law to disclose, at a meeting of the Board of Directors, his interest in such contract, so that the other members of the Board may be aware of the circumstance. The necessity for such a disclosure, in view of the possible conflict of interests, will be self-evident.

The duties of Directors in regard to information to be furnished to the Shareholders of a Company will be found referred to in a separate chapter (Chapter VI).

Directors of Public Companies can, of course, be made liable by law if by reason of their negligence or maladministration the Company has suffered loss.

What constitutes negligence depends upon the circumstances of each individual case. A Board of Directors may have embarked on a policy which ultimately proves to have been ruinous to the Company concerned; but, unless it can clearly be established that at the time when the policy was initiated they acted in a manner notably different from what ought to be expected from a body of common-sense business men, they could not be called upon to make good any of the

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damage suffered. The most efficient and conscientious men are not infallible in their judgments; and it is easy to be wise after the event.

Again, loss or damage may result from the incompetence or wilful wrong-doing of an employee. In theory all the employees of a Company are under the supervision of the Directors; but in practice Directors frequently give, and are justified in giving, wide discretion to certain employees. And, unless it could be clearly established that the Directors had failed to superintend to a reasonable degree under the particular circumstances of the case the acts of any employee, they could not be held legally responsible to contribute towards the cost of any damage suffered by the Company as a result of the shortcomings of the employee.

Furthermore, if Directors, in specially technical matters, seek and take the advice of experts, and, as a result, loss or damage is suffered, the fact that expert information had been obtained would be a defence to any claim made by the Shareholders upon the Directors for loss due to negligence. To what extent it would be a defence would depend, *inter alia*, on the degree to which it might be expected that the Directors themselves, without the aid of expert advice, would be possessed of the necessary experience to come to a decision independently of the expert.

CHAPTER VI

INFORMATION AFFORDED TO SHAREHOLDERS

It is now convenient to review briefly the information concerning the affairs of a Public Limited Company which the Shareholders in that Company are accustomed to receive.

There is certain information to which the Share-holders are entitled by law; and there is other information which it is not obligatory to supply, but which, as a matter of practice, is usually furnished.

Firstly, in regard to information which is obligatory: Shortly after the incorporation of a Company the Directors are required to call what is known as the 'Statutory Meeting' of Shareholders, and at that meeting there is presented to the Shareholders what is known as the 'Statutory Report,' which report is despatched to Shareholders in advance of the date of the meeting. The Statutory Report has to set out certain particulars as to the Capital issued, the cash received in respect of such Capital, and the receipts of the Company and the payments made thereout. A pro forma example of a Statutory Report will be found in Appendix E.

Then the Companies Act requires the holding of an Annual General Meeting of Shareholders, at which meeting there is presented for approval a Balance

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Sheet and Profit and Loss Account and a Report by the Directors with respect to the state of the Company's affairs and the disposal of the available profits. Prior to the coming into operation of the Companies Act, 1929, the submission of a Profit and Loss Account and of a Directors' Report was not obligatory, though it was, in practice, usual. In this connection it might be mentioned that, while the Balance Sheet and Directors' report require to be circulated among the Share-holders before the meeting, the Profit and Loss Account, while it must be submitted at the meeting, need not be circulated. Comments on the provisions of the Companies Act, 1929, which particularly relate to the accounts to be issued by a Public Limited Company will be found in Appendix F.

From Appendix F it will be noted that every Company must keep proper books of account. Such books must at all times be open to inspection by the Directors. It will also be observed that the general lines upon which a Company's Annual Balance Sheet must be drawn up are defined, and, further, that the Balance Sheet must contain certain specified information. Particular classes of items dealt with include Preliminary Expenses incidental to a Company's formation and to the issue of its Capital, Goodwill, Patents and Trade Marks, Commission paid or discount allowed in respect of Shares or Debentures, Loans to Directors.

It will be noted that, except in regard to the disclosure of Directors' remuneration, the Act does not specify, or even indicate, the form in which a Company's Profit and Loss Account is to be submitted. Such an

omission is no doubt wise, bearing in mind, firstly, that the classes of businesses or undertakings owned by Public Limited Companies are many and varied, and that a uniform type of Profit and Loss Account would be impossible, and, secondly, that disclosure of information as to how profits have been earned or losses sustained may conceivably be valuable to a Company's business competitors.

It is necessary to mention here that a full Profit and Loss Account—that is to say an Account showing the gross sales or gross earnings of a business and the various classes of expenditure analysed according to their nature—is very seldom indeed submitted by a Public Company to its Shareholders. The reason for this is, as indicated above, that the information might be very valuable to a Company's competitors, and that it might also induce competition from new quarters. As a rule the Profit and Loss Account submitted with the Balance Sheet is a very abbreviated one: and in the case of a trading Company it is quite usual for it to be in a form such as that appearing on the next page.

It is fair to make the observation that in some cases Public Companies are unduly sparing in the amount of information disclosed in the Profit and Loss Account submitted to the Shareholders, even after making full allowance for any possible harm which may result by reason of information becoming available to competitors as mentioned above.

A few comments are now appropriate in regard to information afforded to Shareholders which is not obligatory. It is the almost universal practice at each

| Profit and | Loss Account | (see previous page). | |
|---|-----------------|--|----------|
| To Directors' Remuneration, Provision for Depreciation of Plant and Equipment, Interest on Deben- | £2,500 | Profit from Trad- ing Account after meeting Working Expenses Income from In- vestments, Bank Deposits, etc | £137,453 |
| tures | 14 250 6,320 | 2 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 | 2,070 |
| "Balance, being net profit for the year —See Balance Sheet | 26,946 | | |
| : | £140,329 | | £140,329 |

Note.—It may be mentioned that the reason why the item of Income Tax is relatively small in relation to the net profits is that such item only represents that portion of the Company's Income Tax assessment which it is unable to recoup by deduction from the interest and dividends payable to the Debenture holders and Shareholders respectively.

Annual General Meeting of a Public Company for the Chairman to make a speech to the Shareholders in which information in regard to the Company's affairs is given in considerably fuller detail than is usual in the Directors' report, which report (together with the Accounts) has been sent out to Shareholders in advance of the date of the meeting. Shareholders present at the meeting have the opportunity of asking any questions which they may desire, though the Directors are not bound to answer them. Inasmuch as the number of Shareholders present at an Annual General Meeting is usually comparatively small in comparison with the total number of Shareholders in the Company, it is a by no means uncommon practice

for a Report of the proceedings at the General Meeting (either in full or in a condensed form) to be printed subsequently and despatched to all the Shareholders, such Report mainly comprising the Chairman's speech.

It is a matter for the consideration of the Board of Directors as to what information should be contained in the printed Report accompanying the Annual Accounts and what information should be included in the Chairman's speech. It is submitted that if there is any information of outstanding importance this ought to be contained in the Report and not confined to the Chairman's speech. It is true that if a verbatim Report of the Chairman's speech is subsequently posted to all shareholders everyone concerned will have the information. This is not, however, the case where the speech is not circulated, and it does not seem right that only those shareholders who are able to attend the meeting should become acquainted with the information in question. And further, even in cases where the speech is afterwards circulated to all shareholders, it is questionable whether the latter ought not to have received the information prior to the date of the meeting. This would at least have enabled shareholders to consider the matter before attending the meeting; it would have permitted those who in any event intended to be present to formulate questions at their leisure which they could ask at the meeting; and it might have induced a number of shareholders to be present at the meeting who otherwise would not have attended.

In many cases Public Companies insert the report of

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the Annual Meeting, including the Chairman's speech, in certain newspapers, and this affords all shareholders who may desire to do so, the opportunity of obtaining the information. Where the shareholders of a Public Company number many thousands, the printing of the detailed Report of the General Meeting and the submission thereof to each shareholder through the post may involve a not inconsiderable amount of time and expense: and this has to be considered.

Not infrequently occasion is taken by the Chairman at a Company's Annual Meeting to make some reference—in general terms—to the progress of the Company's business during the period between the date of the Balance Sheet and the date of the meeting, and also to make some remarks—usually very guarded—as to future prospects. This class of information is perhaps more suitable for submission at the Annual Meeting than by means of the Annual Report accompanying the Accounts, as the Report and Accounts may be said to relate primarily to the Company's financial year which has closed.

It is also a common practice for the Boards of Companies owning certain classes of Undertakings to afford the Shareholders, as a body, information at times other than the occasion of the submission of the Annual Accounts and the holding of the Annual General Meeting. This information may be sent through the post, or it may be published in newspapers. For example, certain public utility Companies, such as Railways, publish periodically their traffic returns; and certain Mining Companies publish periodically

the quantities of mineral won; and the same remark applies to certain Companies owning Plantations, such as Tea, Coffee, and Rubber Plantations, which publish the weights or quantities of the commodities in question which their plantations have produced. A similar procedure is adopted by Oil Producing Companies.

Further, it is not unusual for the Directors of a Company to communicate promptly to the Shareholders information of any specially important event which may have a marked bearing on the Company's fortunes, as, for example, the striking of a rich strata in the case of a Mining Company, or the coming into production of an important well in the case of an Oil Producing Company. As will be appreciated, the chief object of this is to ensure, as far as possible, that all Shareholders receive the information simultaneously, and earlier than the general public, bearing in mind that, sooner or later, the news must become public property. The matter may be of considerable importance in its bearing upon the prices at which the Shares of the Company might change hands on the Stock Exchange.

Not infrequently individual Shareholders in Public Limited Companies ask for information—either specific or general—concerning the Company's affairs, by letter or by calling at the Company's office. What, if any, information shall be afforded—through the medium of the Company's Secretary—in reply to such a request is a matter of policy for the Board of Directors to decide. An individual Shareholder, or group of Shareholders, is not strictly entitled to any information

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which is not given at the same time to the Share-holders as a whole. Obviously, the proper time for a Shareholder to ask for information is on the occasion of the Annual General Meeting, to which all Shareholders entitled to be present have been called.

The reader will probably realize that, of all the information afforded at different times and by various means to the Shareholders of a Public Company, the most important, as a rule, is that embodied in the Company's Annual Balance Sheet. So many matters of importance—from the point of view of the investing public and also of the student of economics—arise in connection with Balance Sheets, and so much misconception in regard to certain of the matters exists, that it has been thought well to deal with the subject in considerable detail. A separate chapter has, therefore, been devoted to the Balance Sheet.

CHAPTER VII

THE BALANCE SHEET OF A PUBLIC COMPANY

It is now convenient to deal with the document which is usually regarded as embodying the most important of all the information periodically afforded to the Investor in a Public Limited Company—namely, the Annual Balance Sheet, which is prepared by the Company's clerical staff under the supervision of the Directors, is examined and reported upon by the Auditors, and is submitted to the Shareholders on the occasion of the Annual General Meeting.

Not a little criticism is heard from time to time in regard to the Balance Sheets of Public Companies, as, for example, that they are in too abbreviated a form to be reasonably informative, or that they are actually misleading. In a certain number of cases there is substance in such criticisms; but in many instances the criticisms are unwarranted in the sense that the critics do not appreciate the principles upon which a Balance Sheet is framed or the limitations to which, by its very nature, a Balance Sheet is subject. A Balance Sheet, if reviewed by someone having little knowledge of what the statement purports to be, may, to that person, be a very misleading document: but, notwithstanding that, it may be drawn up in a perfectly correct manner.

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It is difficult for anyone not having at least an elementary knowledge of Accountancy to understand a Balance Sheet; and the author suggests that, for this and for other reasons which it is not convenient to discuss here, it would well repay anyone whose investments are substantial, or anyone who is fortunate enough to have a surplus income to invest, to devote a little time to the study of the principles of Accountancy.

In the hope that he may make the subject matter of this particular chapter clear to the minds of those readers for whom this book is intended, the author has thought it well to introduce the subject by a series of comments and illustrations which may to many readers seem—and may, in fact, be, so far as they are concerned—unnecessarily elementary. It is, however, necessary, if the picture is to be presented adequately, to commence in quite a simple way; and it is preferable that some readers should be required to peruse a certain amount of information which adds nothing to their existing knowledge than that other readers should find the later parts of this chapter obscure by reason of an insufficient description of elementary matters having been given at the outset.

The comments and illustrations to which allusion has been made above really constitute an endeavour to acquaint the reader in some small degree with the elements of accountancy, but in a manner which, so far as possible, is free from technical accountancy expressions, and which has as its primary object the explaining of the principles upon which a Balance Sheet is drawn up.

As practically every business man knows, a Balance Sheet can broadly be described as a statement of Assets and Liabilities, the Assets being set out on one side of the statement and the Liabilities on the other.

In the case of a concern which is solvent, the Assets, of course, exceed the Liabilities. Conversely, in the case of a concern which is insolvent, the Liabilities must exceed the Assets. But the Balance Sheet must balance; in other words, the items on the one side of the statement must amount to the same total as the items on the other side of the statement. It is therefore clear, either that there must be items on the Assets side of a Balance Sheet which are not Assets, or items on the Liabilities side of a Balance Sheet which are not Liabilities—or that both of these two circumstances exist. The nature of items such as these will be apparent a little later. As a fact a Balance Sheet, in the ordinary case where what is known as the double-entry book-keeping system is in force, is a summary of all the balances on the books of a concern at a certain moment of time, what are known as the debit balances being included on the one side, and what are known as the credit balances on the other side. As the essence of double-entry book-keeping is that 'every debit must have a credit,' and vice versa, the debit balances on the books of a concern at any moment must, in total, equal the total of the credit balances at the same moment. It therefore follows automatically that the totals shown on the left-hand and on the right-hand sides of a Balance Sheet must be identical.

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Without entering into the technicalities of doubleentry book-keeping, it may be mentioned here that Assets are represented in books of account by debit balances, and Liabilities by credit balances. In a Ledger account the left-hand side is called the debit, and the right-hand side the credit; but it is the practice in this country, in preparing a Balance Sheet, to show the debit balances on the right-hand side and the credit balances on the left-hand side.

The description of the nature of a Balance Sheet can perhaps be best continued by means of examples, commencing with those of the most simple character.

Let it be assumed that a newly formed Limited Company issued at the outset (say, just before 31st December, 1928) the whole of its authorized Share Capital, namely 100,000 Shares of £1 each for cash at par; and—for the sake of simplicity—that there were no expenses incidental to the formation of the Company, and that the Company therefore started its existence with one Asset (namely £100,000 represented by cash at Bankers) and with no Liabilities.

On the Assets side (namely on the right-hand side) of a Balance Sheet drawn at that moment of time there would appear one item—namely Cash at Bank, £100,000. What does the £100,000 represent? It can represent nothing else than the whole of the issued Share Capital of the Company, and the Balance Sheet of the Company would therefore appear thus:

BALANCE SHEET, 31ST DECEMBER, 1928

LIABILITIES SIDE ASSETS SIDE Authorized and Issued

Cash at Bank £.100,000

Share Capital, viz. 100,000 Shares of £1

each, fully paid .. £100,000

£100,000

£100,000

In the above, therefore, is seen a case where no Liability appears on the Liabilities side of the Balance Sheet—unless, indeed, the matter be looked at from the viewpoint that the Company as an entity was liable to its Shareholders as individuals for the Capital which they had subscribed.

Let it now be assumed that the Company buys goods on the 2nd January, 1929, for £25,000, for which it pays cash immediately, and that on the same day it buys goods for a further £20,000 on credit. If a Balance Sheet were prepared on the evening of the and January, 1929, it would appear as follows:

BALANCE SHEET, 2ND JANUARY, 1929

| | | | • | • | | | |
|----------|---------|-----------|--------|------------|----------|------|---------|
| I | JIABILI | ries Sidi | Е | | Assets S | SIDE | |
| | | | | Cash at B | ank | • • | £75,000 |
| Creditor | for | goods | | Stock of g | oods in | hand | |
| bought | | | 20,000 | at cost | | • • | 45,000 |
| | | | | | | | |

£120,000 £120,000

The result of this transaction, as will be seen, is that the Company, instead of having one Asset, namely Cash at Bank £100,000 and no Liabilities, has two Assets, namely Cash at Bank and Stock in hand, totalling together £,120,000; but, on the other hand, it owes to a creditor £,20,000; leaving net Assets of £100,000—which, of course, exactly represent the amount of the issued Share Capital.

Now let it be assumed that on the 3rd January, 1929, the Company sells the whole of its stock, which has cost it $f_{.45,000}$, to a customer for the sum of $f_{.50,000}$ on credit. The effect on its Balance Sheet will be that, instead of having on the Assets side 'Stock, £45,000,' it will have 'Debtor, £50,000'; consequently the total of the Assets side of the Balance Sheet will be increased by £5,000. As regard the Liabilities side, the issued Share Capital remains as before, namely £,100,000 and the creditor £,20,000. How, then, is the total of the Liabilities side to be made equal to the total of the Assets side? The fact is, of course, that a profit of £5,000 has been made, and the item which is needed to balance the Balance Sheet is 'Profit, £5,000,' and such item accordingly appears on the Liabilities side.

If a Balance Sheet were prepared on the evening of the 3rd January, 1929, it would appear as follows:

Balance Sheet, 3rd January, 1929

| LIABILITIES SIDE Issued Share Capital . £100,000 Creditor for goods | Assets Side Cash at Bank £75,000 Debtor for goods sold 50,000 |
|---|---|
| bought 20,000 Credit balance on Pro- fit and Loss Account, | |
| i.e. Profit 5,000 | |
| | |
| £125,000 | £125,000 |

It will be noted that in addition to the Issued Share Capital there is now another item on the Liabilities side of the Balance Sheet which is not a Liability, that is to say, the credit balance on Profit and Loss Account, in other words, the Profit.

Let it be assumed that on the 4th January, 1929, the Company paid its creditor the £20,000 owing for goods bought; and let it be assumed that on the same date the Company ascertained that the debtor who owed it £50,000 for goods sold had become insolvent, and that, so far as could be seen, he would only be able to pay his creditors about 10s. in the £. The book debt appearing on the Balance Sheet at £50,000 would only then be worth about £25,000.

If a Balance Sheet had to be drawn up on the evening of the 4th January, 1929, it would appear as follows:

BALANCE SHEET, 4TH JANUARY, 1929
LIABILITIES SIDE
ASSETS SIDE
Issued Share Capital £100,000
Debtor for goods sold after deducting reserve for probable loss on realization 25,000
Debt balance on Profit and Loss Account i.e. net loss to date . . . 20,000

€100,000

£100,000

It will be seen that the effect of the insolvency of the debtor is to turn a profit of £5,000 into a loss of £20,000, the loss being occasioned as follows:

Proportion of the debt estimated to be uncollectable, i.e. half of £50,000 £25,000

Less: Profit on sale of goods, on the assumption that the debtor would be able to pay in full

Net Loss £20,000

Just as in the case where a profit was thought to have been earned, the profit appeared on the Liabilities side of the Balance Sheet, so when a loss has been sustained the amount of the loss appears on the Assets side of the Balance Sheet, and thus the Balance Sheet balances.

The story told by the Balance Sheet of the 4th January, 1929, is, therefore, that, of the Capital of £100,000 subscribed by the Shareholders, £20,000 has been lost, while the remainder is represented by Assets, namely:

| Cash at Bank | | £55,000 | 0 |
|--------------------------------|-----|---------|---|
| Book debt estimated to produce | • • | 25,000 | 0 |
| | | £80,000 | 0 |

From the extremely simple examples quoted above, the following points emerge:

- (a) That items may appear on the Liabilities side of a Balance Sheet which are not Liabilities.
- (b) That items may appear on the Assets side of a Balance Sheet which are not Assets.

Another point which may conveniently be mentioned at this juncture is that Floating Assets, such as Cash at Bank, Book Debts, Stock in Hand, vary from day to day as they are continually changing in form; the same remark is true in regard to Floating Liabilities such as Trade Creditors or Bank Overdrafts. In an ordinary case, therefore, it is impossible to earmark any particular Floating Asset as representing part of the Capital subscribed by the Shareholders of a Company,

or as representing part of the Profits earned but not distributed in dividend.

In the extremely simple case illustrated by the Balance Sheet of 3rd January, 1929, it can definitely be said that the profit of £5,000 is represented by a portion of a specific Floating Asset, namely, the Book Debt of £50,000; in actual practice, however, Balance Sheets are not drawn every few days, but usually half-yearly or yearly, and in the course of such period many changes take place in the Floating Assets and Liabilities.

One occasionally hears an investor, when perusing a Balance Sheet which discloses an undistributed balance on Profit and Loss Account, remark: 'Where exactly is the profit?' The answer is that the profit is merged in the Assets of the business generally, and that it is usually impossible to earmark a particular Asset as representing the whole or any portion of the profit.

The same observation on the part of investors is not infrequently heard in regard to the credit balance on a General Reserve Account which may appear on the Liabilities side of the Balance Sheet. In an ordinary case this balance represents accumulated profits of a past year or years, which have been retained in the business and which, instead of continuing to appear at the credit of Profit and Loss Account, have been transferred, by a book-keeping entry, to the credit of an account called General Reserve Account. Sometimes, it is true, the Directors of a Company decide to make an investment in Stock Exchange Securities of an

amount equal to the amount at the credit of the General Reserve Account, and when this has been done a General Reserve Account (or General Reserve Fund, as it is sometimes termed) is considered as being invested outside the Company's own business, and the balance on the General Reserve Account shown on the Liabilities side of the Balance Sheet thereby becomes earmarked to a specific asset (i.e. Investments) on the Assets side of the Balance Sheet, and in such a case the Asset is usually given a description such as 'Investments in respect of General Reserve Fund.'

But even this earmarking is only retrospective; it cannot be said definitely that the actual cash which was expended in the purchase of the investments represented the profits which had been earned in some past year or years.

For example, a Company's Balance Sheet at the 31st March, 1929, may disclose the following position:

| Liabilities Side | | Assets | Side |
|--|----------|----------------|-----------|
| Share Capital Issued Sundry Creditors | £64,000 | Stock-in-Trade | £20,000 |
| General Reserve Ac- | • | Book Debts | 54,000 |
| count— | | Cash at Bank | 2,000 |
| Balance placed at | | | |
| credit thereof out of | | | |
| the profits of the year | | | |
| to 31st March, 1929 | 10,000 | | |
| Profit and Loss Ac- | | | |
| count—Balance at | | | |
| credit after trans- | | | |
| ferring £10,000 to | | | |
| General Reserve Ac- | | | |
| count | 000, تــ | | |
| | £.76,000 | | £76,000 |
| | ₺,/0,000 | | £, /0,000 |

It will be seen that at the 31st March, 1929, the General Reserve is clearly invested in the Company's business generally, and no one can earmark a particular Asset as representing it. It would be impossible, at the 31st March, 1929, to invest outside the business an amount equal to the balance on the General Reserve Account at that date, unless, indeed, the Company raised special funds for the purpose, either by the issue of Capital or by a loan, as the Cash at Bank was only £2,000.

Let it be assumed that very shortly afterwards, say at the 30th April, 1929, the Company's position is as follows:

| LIABILITIES SIDE | | Assets Side | | |
|--|---------|-------------|----|-----------------------------|
| Share Capital Issued Sundry Creditors General Reserve Ac- | | Book Debts | •• | £20,000 42,000 17,000 |
| count— Balance placed to credit thereof out of the profits of the year | | - | | |
| to 31st March, 1929 Profit and Loss Ac- count— | 10,000 | | | |
| Balance at credit | 3,000 | | | |
| | £79,000 | | | |

In view of the fact that there is a substantial cash balance at the Bank, and assuming that in the opinion of the Board this is not wholly required for purposes of the Company's undertaking, the Directors decide to invest the General Reserve Fund outside the business. They, therefore, purchase Stock Exchange securities

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for £10,000, and the effect of this is that the Balance Sheet will appear as follows:

| Lia | BILITI | es Sid | E | Assets Side | |
|---|--------|---------|---------|--|--------|
| Share Capita Sundry Cred General Re | itors | | 2,000 | Stock-in-Trade Book Debts Investments in respect | 42,000 |
| count Profit and count | | Ac- | • | of General Reserve Account | 10,000 |
| count | •• | •• | £79,000 | Gush at Bank | 7,000 |

It will be seen that the investments are now earmarked to the Reserve Account; but, on a comparison of the Balance Sheet at the 31st March, 1929, with that at the 30th April, 1929, it will be noticed that the reason why there was cash available for the purchase of outside investments at the latter date, but not at the 31st March, 1929, was that much more capital was sunk in the book debts at 31st March, 1929, than at 30th April, 1929. At the former date the book debts stood at £,54,000, while by the latter date they had fallen to £42,000. As already indicated, no one could earmark any part of the book debts at the 31st March, 1929, as representing part of the General Reserve Account at that date; and it follows that no one could earmark the proceeds of realization of any part of such book debts as representing such General Reserve.

The point which has been elaborated above may be of special importance to the Investor in its bearing upon the power of a Company to pay a Dividend in cash to its Shareholders. Such a Dividend can only be paid if:

- (a) Profits are available to an amount not less than the amount of the proposed Dividend, and
- (b) the Company has sufficient liquid resources to enable the distribution to be made.

The existence, on a Balance Sheet, of a credit balance on Profit and Loss Account (and the same remark applies to a credit balance on General Reserve Account) does not necessarily mean that Dividend distributions to an extent equal to such balance could be made to the Shareholders. In fact, it is part of the considered policy of many Companies whose businesses or undertakings are expanding, to finance such expansion in part by the permanent retention in the undertaking of a portion of the profits earned each year, instead of distributing such profits wholly to the Shareholders in Dividend.

Such a policy, while in the great majority of cases very commendable from the point of view of financial prudence, obviously ought not to be carried to extreme lengths. Many of the Shareholders of a Company are doubtless dependent upon their Dividends to meet their living expenses; and even those Shareholders whose financial circumstances are such that they can afford to do without the Dividends, may prefer that the Company should pay reasonable Dividends, and thus afford them, the Shareholders, the choice of re-investing the money so released, than that the Company should automatically re-invest the profits in its own undertaking, or in Stock Exchange securities, thus giving the individual Shareholder no choice in the matter.

On the other hand, of course, the Directors of a Company may be bound, by force of circumstances, to retain in the Company's business the whole, or a large proportion, of the profits earned. For example, the Company may have no more Floating Capital than is barely sufficient for its needs, or it may be faced with the knowledge that, in the interests of its business, further Capital will shortly be required, as, for example, to provide for additions to fixed Assets, such as buildings and plant. The Company's circumstances for the time being may be such that it cannot raise additional Share Capital—or Debenture Capital—on reasonable terms, nor may temporary financing by means of loans from Bankers or others be desirable. In such circumstances the only practical course may be to strengthen the financial position by the retention of the profits in the business; and the Shareholders should realize that this, taking the long view, is in their best interests.

As regards Assets, the only class of Asset which has, so far, been considered in this particular chapter is what are known as Floating Assets, such as Stock-in-Trade, Book Debts, and Cash at Bankers. It is now convenient to introduce, in their particular relation to Balance Sheets, what are known as Fixed Assets, such as Land, Buildings, Plant and Machinery. It may be well to begin with an extremely simple illustration of a Balance Sheet containing Fixed Assets.

Let it be presumed that a Company raised Share Capital for cash to the extent of £100,000, and that it immediately acquired certain Fixed and Floating

£,100,000

Assets. Let it be assumed that at the inception of the Company the position, expressed in the form of a Balance Sheet, was as follows:

| Share Capital issued £100,000 | Cost of Land acquired | €10,000 |
|-------------------------------|------------------------|---------|
| - | Cost of Buildings ac- | |
| | quired | 20,000 |
| | Coat of Plant and | |
| | Machinery acquired | 30,000 |
| | Cost of Stock-in-Trade | 20,000 |
| | Cash at Bank | 20,000 |
| | | |

€,100,000

Let it be assumed that no further purchases of Land or Buildings or Plant and Machinery are made during the first year of the Company's existence; that the Company carries on its business successfully; and that at the end of the year it has to prepare a Balance Sheet on which will appear the profit which it has made for

the year.

As regards its Floating Assets, it finds that it has Cash at Bank totalling £25,000; Stock-in-Trade which has cost it $f_{.30,000}$ (but of which, owing to a change in fashion, stock costing £4,000 is only worth £3,000); and book debts of £10,000 (of which one debt for $f_{1,000}$ is estimated to be worth only 10s. in the $f_{1,0}$. As regards Liabilities, these total £,10,000.

The general principle upon which Balance Sheets are drawn up as regards Floating Assets, is that the values of such Assets have to be reviewed, and if, for any reason, a Floating Asset stands in the Company's books at a figure in excess of its true value, it must be written down to that extent-in other words, the

difference must be considered as a loss. Following this principle in the case under consideration, the Floating Assets would be inserted in the Balance Sheet at the end of the Company's first year at the following figures:

| Book debts (totalling £10,000) | £29,000 9,500 25,000 |
|---|----------------------------|
| And if from this total there are deducted the | £63,500 |
| Creditors at the same date, viz.: | 10,000 |
| the Floating Capital employed in the Company's business at the end of the year is arrived at, viz.: It will be remembered that the Floating | £53,500 |
| Capital at the beginning of the year was composed as follows: | |
| Stock-in-Trade £20,000 Cash at Bank 20,000 | |
| | 40,000 |
| Therefore there has been an accretion to the Floating Capital during the | |
| year to the extent of | £13,500 |

which, if there were no Fixed Assets utilized in the business, would represent the profit earned during the year.

The next question to consider is that of the manner in which the Fixed Assets should be treated for Balance Sheet purposes.

As already mentioned, no fresh acquisitions of Land, Buildings, or Plant have been made during the year; and let it be assumed that the whole of the Land, Buildings, and Plant purchased at the beginning of the year is in existence at the end of the year.

The general principle upon which Fixed Assets are included in a Company's Balance Sheet is that they appear at their cost to the Company, subject to a deduction to represent an estimate of the diminution in value which may have arisen from wear and tear and obsolescence. Following this principle, there is obviously no wear and tear taking place with regard to the Land, as this Asset is of a permanent character. As regards the Buildings, presumably some diminution in value must arise from the above-mentioned cause although such diminution would relatively be quite small. Let it be presumed to be at the rate of $f_{.300}$ per annum. As regards Plant and Machinery, the diminution arising from wear and tear and obsolescence would relatively be much greater, as these Assets would have a much shorter economic life than the Buildings. Let this diminution in value be estimated to be at the rate per annum of 7 per cent. on the cost of the Plant and Machinery, or, in other words, at the rate of $f_{12,100}$ a year.

In view of the above circumstance, the item of Buildings would be inserted in the Balance Sheet at £19,700 as compared with its cost of £20,000, while the item of Plant and Machinery would appear in the Balance Sheet at £27,900 as compared with its cost of

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The Balance Sheet would then appear as follows:

| Share Capital Issued £100,000 Sundry Creditors 10,000 Profit for the year 11,100 | Land at cost | 27,900 29,000 9,500 25,000 |
|--|--|-------------------------------------|
| £121,100 | £ | 121,100 |
| The profit for the year of above would be represented in the Flooduring the year, as tioned, of Less: Estimated diminution in value of the buildings of to wear and tear | sented by an ating Capital already men- the | 3,500 |
| Estimated diminution in value of Plant and Mach | the | |
| owing to wear and tear | 2,100 | |
| | | 2,400 |
| Profit as above | 7e £1 | 1,100 |

Before making further comments on matters concerning Fixed Assets, it may be mentioned here that the law (as interpreted by cases decided in the Courts) draws a clear distinction between depreciation of a

Fixed Asset and depreciation of a Floating Asset, incidental to the preparation of a Balance Sheet and the consequent ascertainment of the profit or loss which a Company may have made. It is held to be illegal for a Company to pay dividends out of 'Capital,' and this, to the mind of the economist, would imply that dividends can legally only be payable out of 'profits.' The term 'profits,' as most business men are aware, is a very elastic one, and the Legislature has, very wisely, not attempted to define it too closely. But it has been decided in the Courts that in arriving at profits available for the payment of Dividend, diminutions in the values of Floating Assets taking place during the year must be taken into account, but that diminutions in the value of Fixed Assets need not necessarily be taken into account. For example, a Company may have paid a certain sum for a leasehold property: such a Company could, legally, distribute in Dividend the profits arising from the use of the property, without making a deduction in respect of the diminution in the value of the lease. It should, however, be added that, while what may be termed 'legal' profits can be arrived at before allowing for the depreciation of Fixed Assets, true economic profits are only computed after allowing for such depreciation; and the recognized practice in the great majority of cases is to make provision in a Company's accounts for the depreciation. In other words, the view of the economist would be that it is misleading to talk of profits so long as Capital is not intact.

Turning now to the Fixed Assets set out in the last

Balance Sheet referred to, let it be assumed that at that date (that is to say, one year after the Company had acquired the Assets in question) the market value of business property in the neighbourhood had increased, and that as a result the Land and Buildings for which collectively the Company had originally paid £30,000 were worth about £35,000.

According to the principles on which Balance Sheets are drawn up, the accretion in the market value of these Fixed Assets would have no bearing on the matter—in other words, it could not be taken into account in arriving at the profit which the Company had earned, although it naturally strengthens the position of the Company.

As regards the Plant and Machinery, let it be assumed that, owing to improved means of manufacturing such Plant, Plant exactly similar to that for which the Company had paid £30,000 could have been bought by the Company at the end of the year (i.e. at the date of the Balance Sheet now being considered) for $f_{125,000}$. According to the principles upon which Balance Sheets are drawn up, such a circumstance would not ordinarily be taken into consideration. The Fixed Asset 'Plant and Machinery' would appear in the Company's Balance Sheet each year at what it had cost, less a deduction for wear and tear and obsolescence based on the estimated economic life of the Plant, and the question of the prices at which the manufacturers were willing to supply similar Plant at a subsequent time would not be reflected in the Balance Sheet.

A little consideration will enable the reader to appreciate the reasons which lie behind the principles illustrated and explained above. The Floating Assets are those in which the Company is trading; they are changing from day to day from one form to another. If, to take Book Debts as an example, it is found that a debtor will be unable to pay in full, it would be foolish to pretend that until the portion recoverable is actually collected no loss can have occurred to the Company to whom the money is owing. Therefore for purposes of preparing the Balance Sheet a valuation is put upon this Floating Asset. Similarly in regard to the Stock-in-Trade, if, owing to a change of fashion during the period when the Company has held certain stock, a portion of the stock declines in value and can only be sold at a loss, it would be foolish to suggest that the Company owning the Stock has only suffered the loss when the Stock is actually disposed of.

But in regard to Fixed Assets, such as Land, Buildings, Plant, and Machinery, the case is very different. These Assets have not been acquired by the Company in order to be sold; they have been acquired to enable the Company to carry on a business of a particular character. What may be their value in the market—for perhaps entirely different purposes—is immaterial to the Company. That to some other party they may be worth more or less than the figure at which they may appear in the Company's Balance Sheet is no concern of the Company. All that the Company has to consider, from the point of view of the preparation of its Balance Sheet, is that it is subjecting certain of these

Assets to wear and tear in the course of using them in its business, and that they may also be subject to obsolescence; this wear and tear and obsolescence should, economically, be taken into consideration in computing what the true profits of the Company are. This will become clear if a simple illustration be taken.

Let it be assumed that a limited Company is formed to carry on business as a Butcher. For that purpose it buys a freehold shop in a new district and pays, say, £1,000 therefor. In the course of five years the district develops, and shops of the same size and character are fetching, say, £3,000 in the market. In one sense the Company may be said to have made a profit, but the shop has not changed, and it is no better adapted for the butchering business than it was before. Until the Company sells the shop it will continue to figure in the Balance Sheet at the cost less depreciation. When the Company sells the shop for more than the cost it will make a capital profit, but not a trading profit, as the Company does not trade in buying and selling shops, but in buying and selling meat.

Reference may now be made to an Asset which may perhaps be described as a Fixed Asset, although it is an intangible and not a tangible one. The Asset in question is 'Goodwill.' Most business men have a general idea of what is meant by the term Goodwill in a financial sense. A number of definitions of Goodwill have been given by competent authorities from time to time. Goodwill has been described as the benefit and advantage of the good name, reputation, and connection of a business. It has been stated that a payment

for Goodwill is a payment to place the purchaser in a position to earn more money than he would be able to do by his own unaided exertions. Another authority has said that the amount paid for the purchase of Goodwill really represents a premium paid to secure an extra profitable opening for the employment of Capital. From an Accountancy point of view Goodwill may perhaps best be described by saying that it represents the capitalized value of actual or prospective superearnings. The expression 'super-earnings' means the balance of net profits remaining over after deducting a sum equivalent to a fair return upon the Capital employed in a business, the percentage rate of such return depending upon the nature of the Capital employed and the class of business. If, for example, the earnings of a business—say, an Engineering business -after providing adequately for depreciation, only amounted to some 8 per cent. on the value of the Capital employed in that business, and if there was no strong probability of the earnings materially exceeding that level in the future, no Goodwill of the business could be said to exist. The owner could not sell the business as a going concern for a higher figure than the value of the Capital embarked in it—in other words, the value of the total tangible Assets less the Liabilities.

The basis upon which Goodwill appears in the Balance Sheet of a Company is that of its cost—i.e. what the Company has paid for it. In a number of cases public Companies who have paid a certain sum for the Goodwill of businesses which they have acquired, gradually write down in their Accounts the cost of the

Goodwill, the effect of which is that Goodwill appears in their Balance Sheets each year at a reducing figure, finally, it may be, disappearing altogether. Such a course does not necessarily imply that the real value of the Goodwill has declined or disappeared; it merely means that the Company desires to strengthen its Balance Sheet by reducing and finally eliminating from its Accounts an item included among its Assets which is of an intangible character, the real value of which, should the earning capacity of the Company unfortunately decline, must also decline.

The expression 'writing down the Goodwill' means in an ordinary case that the writing down has been effected 'out of profits,' or, to use an equivalent expression, by an 'appropriation of profits.' What such a step actually means from an Accountancy point of view can best be made clear by a simple illustration.

Let it be assumed that the following is the Balance Sheet of a Public Limited Company:

| Share Capital Issued £100,000 Sundry Creditors 10,000 Balance on Profit and | |
|---|---|
| Loss Account repre- senting undistributed | tion 35,000 Stock in hand at or |
| profits 30,000 | under cost 30,000 Book Debts 40,000 Cash at Bank and in |
| | hand 25,000 |
| £140,000 | £140,000 |

As will be appreciated from explanations already given in this chapter, the accumulated but undistributed profits of £30,000 are merged in the general

Assets of the business, and cannot be earmarked to any specific portion of any particular Asset or Assets.

There may be said to be three main courses open to the Company in considering how to deal with the item of £30,000 representing undistributed profits:

- (a) To distribute the whole or a portion of it in the payment of Dividend to the Shareholders.
- (b) To allocate the whole or a portion of it to some special Reserve Account, or to write down some specific Asset in the books.
- (c) To do nothing at all, but to leave the balance on Profit and Loss Account entirely unappropriated.

Let it be assumed that it is decided to distribute £10,000 in dividend; to carry £10,000 to a General Reserve Account; to apply £5,000 in writing down Goodwill; and to leave £5,000 on the Profit and Loss Account.

When this has been done the Balance Sheet will appear as follows:

| Share Capital Issued £100,000 | |
|-------------------------------|--------------------------------|
| | amount written off £5,000 |
| General Reserve | Premises and Plant at |
| Account 10,000 | cost, less depreciation 35,000 |
| Unallocated balance on | Stock-in-Trade at or |
| Profit and Loss Ac- | under cost 30,000 |
| count 5,000 | Book Debts 40,000 |
| • | Cash at Bank and in |
| | hand 15,000 |
| £125,000 | £125,000 |

The very important distinction between the distribution of £10,000 in Dividend on the one hand, and

the appropriations to General Reserve Account and in reduction of Goodwill on the other hand, should be noted. The payment of the Dividend represents a real transaction, and depletes the Company's resources by £,10,000; in other words, the cash at Bank is reduced to that extent. But the other two appropriations do not represent real transactions, but merely book-keeping entries. The Company, or its business, is no better or no worse off because $f_{10,000}$ appears on the Liabilities side of the Balance Sheet under the heading of General Reserve Account instead of being included in the balance on Profit and Loss Account. Nor is the Company, or its business, in any way affected because the Asset Goodwill has been written down in its books by $f_{.5,000}$ and a corresponding sum deducted from the balance on Profit and Loss Account. The question, then, naturally arises, 'Why, if such is the case, do the Directors of the Company suggest, and the Shareholders acquiesce in, these two appropriations being made out of the credit balance remaining on Profit and Loss Account after the Dividend of £10,000 has been disbursed?' The answer, not improbably, is as follows:

The Directors consider that, in order to retain in the business liquid resources which shall be adequate to meet all contingencies which are at all likely to occur, it is inadvisable to distribute in Dividend more than £10,000. They could, it is true, allow the remaining £20,000 to stand at the credit of Profit and Loss Account, but it does not seem to them likely that circumstances will at some future date warrant the

whole, or even the bulk, of this £20,000 being distributed in Dividend, and Shareholders may be apt to regard a sum standing at the credit of Profit and Loss Account not merely as one which can legally be distributed in Dividend, but one which can justifiably be distributed in Dividend on ordinary economic grounds. Hence the Directors consider it advisable to transfer the larger portion of that sum to other Accounts. There remains the choice, in regard to the sum so to be transferred, between placing it to a General Reserve Account or using it to write down the book value of an Asset. The advantage of utilizing some of it to write down the Goodwill is that the smaller the figure at which the Goodwill stands in the Balance Sheet the less is the likelihood that at some future time the book figure of Goodwill appearing in the Balance Sheet will be greater than the real value of the Goodwill-in other words, the more conservatively will the Balance Sheet be drawn up. On the other hand, the advantage of making a transfer to a General Reserve Account is that the balance on such Reserve Account is available at any future date for writing off any exceptional trading or other loss which the Company may sustain. If, for example, the Company made a trading loss for one or more years, with the result that the balance of the Profit and Loss Account appeared on the Assets side of the Balance Sheet, such balance could be written off against (in other words, be made to cancel out) a corresponding amount of the General Reserve Account. This would permit when, in subsequent years, profits were once more earned, such profits being distributed

in Dividend instead, as would ordinarily be the case, of their being retained in the business until they were sufficient to cancel the adverse balance on Profit and Loss Account which had accumulated in a previous year or years. (In making the above remark it is, of course, assumed that at the time when the payment of the Dividend was considered the liquid resources of the Company were sufficient to enable such a disbursement to be made.)

Bearing all the above considerations in mind, the Directors, one will assume, come to the decision to adopt a middle course, and they, therefore, deal with the £20,000 as follows:

| By writing down Goodwill by | | £5,000 |
|--|-----|--------|
| By transferring to General Reserve Account | an | |
| amount of | | 10,000 |
| By leaving on the Profit and Loss Account | • • | 5,000 |

€20,000

As already mentioned, these appropriations do not represent real transactions; but they may be very desirable, nevertheless, from the point of view of general policy. The real position of the Company is unchanged by reason of the appropriations; but the position as shown by the Balance Sheet is different.

The same point is noticeable in regard to such matters as the provision which a Company makes for depreciation of Fixed Assets which are subject to wear

and tear. No book-keeping entries, obviously, can alter the amount of wear and tear actually occurring each year; but the appearance of the Balance Sheet is altered according to the amount of provision which the Company thinks it necessary to make in its Accounts in this connection. If the amount provided by the Company in its Accounts is in excess of the wear and tear actually occurring, then the Fixed Assets, after deducting the provision for wear and tear, stand in the Balance Sheet at a figure which is lower than necessary, and to this extent the Balance Sheet is conservatively drawn up. Conversely, if the sum provided by the Company in its Accounts is less than the amount of wear and tear actually occurring, then the Fixed Assets in question, after deducting the provision made, stand in the Balance Sheet at too high a figure, looking at the matter from the point of view of the principles upon which a Balance Sheet is ordinarily drawn up.

From what has been said above, therefore, it will be noted:

- (a) That changes may appear in a Company's Balance Sheet without any change at all having taken place either in the Company's Assets or in its Liabilities, and
- (b) that changes in the values of certain classes of Assets of a Company may take place without any changes at all appearing in respect of such Assets in the Company's Balance Sheet.

And generally in regard to Assets, it is to be noted that:

- (a) Floating Assets, such as Book Debts and Stock-in-Trade, are, as a rule, capable of fairly exact valuation; and such Assets usually appear in Balance Sheets at amounts approximating to their current value, or, at any rate, at amounts not in excess of their current value.
- (b) Fixed Assets, on the other hand, are frequently not capable of exact valuation. What their real value may be is often a matter of opinion on which widely divergent views may be held. Further, the Asset may have one value for a certain purpose and another value for another purpose. It may also have one value to one prospective buyer, and quite another value to another. And, again, it may have one value as forming a part of a going concern, and another value altogether if it is to be sold separately from the business as a whole. A Company's Balance Sheet does not purport to show Fixed Assets at their real or realizable value, quite irrespective of whether such real value is, or is not, capable of being estimated with any precision. The Balance Sheet purports to show them at what they appear in the Company's books, which is usually the cost to the Company, less any sums by which the Company may have chosen to write them down below their cost, as, for example, in respect of depreciation.

One or two further comments on Fixed and Floating Assets seem called for here.

An Asset is not classed as being a Fixed one (or, alternatively, a Floating one) by reason of its nature, but by reason of the use to which it is put by the concern owning it. The question, for example, as to

whether an Asset is movable or non-movable has no bearing on the matter.

Two men in business on the Thames side may have among the Assets in their Balance Sheets a number of rowing-boats. One man's business is to make the boats and sell them; the other man's business is to let boats out on hire. The first man is a dealer in boats; his boats on hand at any time represent his Stock-in-Trade, and as such they are Floating Assets. The second man does not buy and sell boats; he carries on his business by the use of boats. In such a business the boats, although they float, and although they are movable, are not Floating Assets, but Fixed Assets.

Let it be assumed that both men prepare their Balance Sheets as at the same date. In the Balance Sheet of the boat-builder, whose boats constitute the Stock-in-Trade, such boats would appear at cost, except that if, at the date of the Balance Sheet, the market value of new boats of this description was lower than the cost the boats would be written down to the market value. On the other hand, the man who let out the boats on hire would not be concerned in any way with what the market value of such boats was at the date of the Balance Sheet. His boats would appear in his Balance Sheet at what they had cost him, less whatever provision he thought was necessary in order to provide for the accumulated wear and tear which had resulted from their use.

The general point illustrated above is frequently observable in the Company world in connection with investments—say, for example, Stock Exchange securities.

To some Companies, holdings in Stock Exchange securities constitute a Fixed Asset, while to other Companies they constitute a Floating Asset. As the reader is probably aware, there are a number of Companies which are termed 'Investment Trust Companies,' whose function is to purchase securities of various kinds and to distribute the income received from such securities among their own Shareholders. Such Companies may from time to time change their holdings by selling one investment and buying another with the proceeds, but their main function, and the primary object for which they were formed, is, as stated above, to hold investments and to distribute in Dividend to their Shareholders the income received therefrom.

Another group of Companies is known as 'Finance Companies.' Finance Companies also embark their Capital in investments, but their functions are different from those of the Investment Trust Companies. Their primary object is to deal in securities (i.e. to buy them with the object of selling them at some later date at a profit) and to enter into various financial transactions in which their remuneration or profit is frequently receivable in the form of securities. To such Companies the securities held at any time represent Floating Assets and not Fixed Assets; in fact, they may be said to be similar to the Stock-in-Trade in the case of a Trading Company.

In arriving at its profits available for Dividend, an Investment Trust Company is under no obligation to provide for any depreciation which may have occurred in the market value of its investments. Whether or not such a Company does, in fact, provide for such depreciation, if any, is a matter determined by policy: it can, of course, do so should it so desire. On the other hand, as regards the Finance Company, it would be proper and usual, in preparing a Balance Sheet, to provide for any depreciation occurring on the securities which it held, measured by reference to the market price at the date of the Balance Sheet.

It is convenient here to make a few remarks on the principles on which stocks of materials and commodities are valued for Balance Sheet purposes.

In the first place, the question of what is generally termed 'Stock-in-Trade' may be considered. The term Stock-in-Trade means ordinarily stock which a concern has bought for purposes of re-sale. As is generally known, the usual basis of valuing Stock-in-Trade for Balance Sheet purposes is that of appraising it at its cost, or at its market value if such market value at the date of the Balance Sheet happens to be less than its cost. For example, a retail store may have a stock of a certain class of gloves in hand at the date of the Balance Sheet which had cost it 48s. a dozen, and its selling price of gloves of this class might be 6os. a dozen—in other words, the retail store would be in the habit of making on such gloves a gross profit at the rate of 12s. a dozen.

Let it be assumed that at the date of the Balance Sheet the wholesalers' price for supplying such class of gloves to the retailer had fallen to 45s. a dozen. If

this lower price were to continue, then the probability would be, in an ordinary case, that in due course the price which the retailer charged for this class of gloves would be reduced. Let it be assumed that such reduction would amount to 3s. a dozen—in other words, that the retailer would then sell that class of glove at 57s. a dozen instead of at 6os. a dozen.

What is the position of the retailer in regard to his stock of gloves on hand at the date of the Balance Sheet, assuming that, from his point of view, the most unfavourable happening occurs—that is to say, that the general retail price of the gloves will fall immediately after the date of the Balance Sheet by 3s. a dozen?

If the retailer brings the gloves into his Balance Sheet at what they cost him, namely, 48s. a dozen, he knows that, when he comes to sell them during the subsequent financial year, he will only show in such period a gross profit on them of 9s. a dozen, as against his ordinarily expected profit at the rate of 12s. a dozen.

It would be in accordance with usual commercial practice in such a case for the retailer to write down his stock of gloves from 48s. a dozen to 45s. a dozen—in other words, to bring a 'loss' of 3s. a dozen into the financial period ended on the date of the Balance Sheet, with the result that in the subsequent financial period, when the gloves are actually sold, the normal rate of profit of 12s. a dozen will emerge. It could, of course, be argued that the retailer has not, in fact, sustained any real loss in connection with these gloves up to the date of the Balance Sheet, nor will he ever sustain an actual loss in connection with the sale of them, as a

margin of gross profit at the reduced rate of 9s. a dozen may still be sufficient to enable him to meet the proportionate part of the working expenses of his business, which, of course, have to be charged before any net profit is arrived at. If, of course, the margin of gross profit at the rate of 9s. a dozen were insufficient to meet the proportionate part of the working expenses of the business, there would be no question whatever but that the gloves should be written down in the Balance Sheet to some price lower than their cost of 48s. a dozen.

In brief, while the general basis adopted for the appraisal of Stock-in-Trade, namely cost or market value, whichever is lowest at the date of the Balance Sheet, can be whole-heartedly supported on grounds of prudence and the conservative framing of a Balance Sheet, it does not follow that in all circumstances some less conservative basis may not be justifiable.

Quite a different class of stock in hand is represented by stock which a business may use for its day-to-day purposes, but which is not destined for sale. Under this category would come stores held by a Railway Company for purposes of repairing, maintaining, or operating its undertaking—as, for example, coal, timber, rails, and various kinds of engineering stores. If, at the date of the Balance Sheet, the market value of any of these classes of stores were lower than the cost to the Railway Company, this fact would not ordinarily be taken into account in valuing the stores for purposes of preparing a Balance Sheet. But if, for example, any of the stores had deteriorated owing, for instance, to

exposure to weather, such deterioration would be taken into account; or, alternatively, if a certain type of store had become partly obsolete, and it seemed likely that for this cause it might not ultimately be used, and that it would, therefore, have to be sold, presumably at a loss, this obsolescence would be taken into consideration. In other words, the book value of the stores would require to be written down.

In the case of certain classes of enterprises it is usual and proper to value stocks for Balance Sheet purposes at a figure which may be in excess of the cost of the stocks to the Company in question. For example, a Rubber Plantation Company which had harvested, but not sold, a certain quantity of rubber to the date of the Balance Sheet, would be justified in bringing such stock into its accounts not on the basis of what it had cost it to produce, but on the basis of what it expected to realize for it, after making allowance for costs incidental to the sale, and probably after making some allowance for contingencies such as a fall in the market price. Similar remarks would apply to Companies owning concerns such as Cotton Plantations, Coffee Plantations, and the like.

A question which may naturally arise in the mind of the reader is why, if the Rubber Plantation Company can value its stock of rubber at the net selling price it expects to receive for it, cannot the Company owning the retail store and selling the gloves value its gloves in stock at what it expects to receive when it sells them, less a deduction in respect of a proportionate part of the anticipated expenses of selling?

The answer is that the main functions of the two undertakings are quite different in character. The function of the one, namely, the Rubber Plantation concern, is to produce rubber; the function of the retail trading concern is to attract a buyer for the gloves. Rubber commands a certain price on the rubber market, and by a stroke of the pen, so to speak, the Directors of the Rubber Plantation Company can dispose, in a moment, of the whole of the stock of rubber which they have brought to a saleable condition. In other words, the rubber in their hands is an immediately realizable asset. Those in charge of the retail store, however, have not the power to sell immediately the whole stock of gloves in their hands at the price at which they are ticketed in their shop window. By a stroke of the pen they can buy from the wholesaler practically any quantity of the gloves at the current wholesale price; this is not, however, their main function. Their main function is to induce the public to absorb, singly, the gloves, and to this end their main energies are directed.

To take an extreme case in illustration of the principles described above, it would obviously be absurd if the retailer bought, just before the date of the Balance Sheet, a very large quantity of gloves, and took credit, in his Accounts ended on that date, for a profit which he hoped to be able to make during, perhaps, the next year or two by selling the gloves piecemeal to the public. Correspondingly, it would be absurd to consider that a Rubber Plantation Company which, during the financial year, had harvested and made

available for sale a large quantity of rubber, which it could at any moment dispose of at a substantial profit, had, in fact, earned no profit during such year, merely because it had not thought it advisable to realize the rubber prior to the date of the Balance Sheet.

Before leaving the subject of stocks in hand incidental to the preparation of a Balance Sheet, it may be well to touch briefly on the question of what is commonly known as 'Work in Progress.' The most common instances where work in progress represents a very important Asset on a Balance Sheet are those of Engineering Companies and Contracting Companies. Such work in progress, of course, represents expenditure in materials, labour, etc., on specific pieces of work or 'jobs' which are uncompleted at the date of the Balance Sheet.

Speaking generally, the usual basis on which work in progress is valued for Balance Sheet purposes is that of its cost, such cost including, in addition to the actual materials used and the labour expended on the particular work, a proportionate part of the general overhead expenses of the business. In some cases it is the practice not to include, in valuing the Work in Progress, any proportion of the above referred-to overhead charges. This, however, is a measure of prudence and conservative policy; on logical grounds the inclusion of the proper proportion of overhead charges is clearly justified. If, of course, it is believed, in the light of information available at the time when the Balance Sheet is being prepared, that any of the 'jobs' in question will ultimately show a loss, then a provision in

respect of this would be made; in other words, the work in progress would be valued at a figure less than its cost.

An exception to the above referred-to general rule is frequently to be found in the case of Companies undertaking large work under contract. In certain cases the work under such a contract may continue for a lengthy period of time and may involve a very heavy expenditure, both in labour and materials; further, it may be quite practicable to estimate, at certain stages of the work, the proportionate part of the profit which can fairly be attributed to such portion. In such cases it is quite usual for the Contracting Company to take credit for profit on uncompleted work. Such estimated profit would, of course, be arrived at on a conservative basis—that is to say, after allowing a margin for contingencies. It will be appreciated that if a Contracting Company undertaking relatively few but correspondingly large pieces of work-such as the construction of harbour works, or of large bridges, or of a railway-were to adhere strictly, in regard to the item of work in progress, to the basis of 'cost' in preparing its Balance Sheet, it might submit to its Shareholders, for one or two years, Accounts showing no profit whatever, and in a subsequent year its Accounts might disclose a very large profit which had, in fact, been earned not wholly in that year, but over a whole series of years.

The question of the provision for depreciation of Fixed Assets—such as Buildings, Plant, Machinery, etc.—incidental to its effect upon a Balance Sheet has

already been touched upon once or twice. But the subject is an important one; some aspects of it are not always clearly understood; and it has therefore been thought well to enter into it in a certain amount of detail.

As has already been explained, the mere making—or neglecting to make—in a Company's Accounts a provision for depreciation does not alter the real state of affairs. The deterioration of certain classes of Fixed Assets owing to what is commonly known as 'wear and tear,' is a process which obviously goes on irrespective of whether those in control of the Company's affairs choose to make an entry in that connection in the books of Account or not.

When one speaks of making a provision for depreciation in the books one has in mind, of course, the charging of the sum in question to Profit and Loss Account; in other words, the exhibiting on the Liabilities side of the Balance Sheet of a balance on Profit and Loss Account which is less than it would otherwise have been to the extent of the amount of the provision for depreciation. As a result, a correspondingly smaller balance on Profit and Loss Account is shown on the Balance Sheet as available for dividend to the Shareholders; and if it happens to be the Company's practice to distribute among its Shareholders in dividend the whole, or substantially the whole, of the balance shown on Profit and Loss Account, then the fact that the provision for depreciation has been made. has reduced by that or by some similar extent the amount distributed as dividend. If such be the case,

then the effect of the provision for depreciation has, in this instance, been that certain Floating Capital remains in the business which would otherwise have been paid out to the Shareholders in dividend.

In the case of a business having very large Fixed Assets, the provision for depreciation accumulated over a series of years may well amount to a very large sum; and where a business is expanding, and consequently requires from time to time additional resources, the fact that there is a large depreciation reserve is of great importance, as the extra resources which that reserve represents obviate, or at least alleviate, the necessity for the obtaining of fresh Capital from the existing Shareholders or from the public.

One or two simple illustrations will make the foregoing remarks clear.

Let it be assumed that a Company has been formed to operate a new manufacturing business, and that to that end it has acquired some land, erected its own works thereon, and installed plant and machinery in the works. Let it be assumed that at the end of the first year's operation of the works the position is shown by the following Balance Sheet:

| Issued Share Capital £100,000 Trade Creditors 7,000 Profit and Loss Account | Land at cost £ Works and Plant at cost 7 Stock-in-Trade and | 3,000 6,000 |
|---|---|-------------------------|
| —balance at credit before providing for depreciation of Works and Plant 9,000 | Work in Progress 11 Debtors 11 | 2,000 6,000 9,000 |
| £116,000 | £110 | 6,000 |

Let it be presumed that a proper estimate of the annual depreciation on Works and Plant is £4,500, and that the Directors decide to make a provision to that extent by charging this sum to Profit and Loss Account, and then to distribute in dividend the balance remaining on Profit and Loss Account.

After this appropriation and distribution of Dividend the Balance Sheet would appear as follows:

| Share Capital Trade Creditors Reserve for depreciation | (100,000 Land at cost | | | | £3,000 |
|--|-----------------------|---------|-----------------------|----|----------|
| of Works and Plant | 4,500 | ciation | per contra n-Trade | a) | 76,000 |
| | | Work i | n Progress | | 12,000 |
| | | Debtors | | | 16,000 |
| | | Cash . | • •• | •• | 4,500 |
| | £111,500 | | | | £111,500 |

An alternative method of dealing with the question of depreciation, so far as the setting out thereof in the Balance Sheet is concerned, would be to deduct it from the cost of the Works and Plant. In this case the Balance Sheet would appear as follows:

| Share Capital | £100,000 | Land at cost | | £3,000 |
|-----------------|----------|----------------|---------|----------|
| Trade Creditors | 7,000 | Works and Plan | it less | 1 |
| | | depreciation | | 71,500 |
| | | Stock-in-Trade | | |
| | | Work in Progre | ss | 12,000 |
| | | Debtors | | 16,000 |
| | | Cash | • • | 4,500 |
| | | | | |
| | £107,000 | | | £107,000 |

Whichever method of dealing with the item of depreciation is employed in framing the Balance Sheet is immaterial; the facts remain unaltered. And the facts are that the amount of the provision for depreciation is invested in the business; in other words, it is represented by some portion of the Assets of the business, though it cannot necessarily be earmarked to any particular Asset or Assets.

Let it be presumed that the business continues year by year to prosper and expand, and that the expansion necessitates the purchase of additional Plant and Machinery. The increased output also entails additional Floating Capital in the form of Stock-in-Trade and Work in Progress and Book Debts.

At the end of the tenth year, after paying the dividend in respect of that year, the position, let it be assumed, is as follows:

| Share Capital | £,100,000 | Land at cost | |
|--------------------------|-----------|--------------------|---------|
| Trade Creditors | 9,000 | Works and Plant: | |
| Reserve for depreciation | ٥, | Originally | |
| of Works and Plant | 48,000 | erected or ac- | |
| Undistributed balance | • 1 | quired£,76,000 | |
| of Profit and Loss | | Additional Plant | |
| Account | 3,000 | subsequently | |
| | • | purchased 37,000 | |
| | | - | 113,000 |
| | | Stock-in-Trade and | - |
| | | Work in Progress | 17,000 |
| | | Debtors | 19,000 |
| | | Cash | 8,000 |

From the above Balance Sheet it will be seen that even though the Company has, during the ten years, distributed practically all its profits in dividend, and although it has not had to call upon Sharcholders or the outside public to provide any additional Capital, it has yet been able to finance the large additions (£37,000) to Plant and Machinery made during the ten years, and also to provide the additional Floating Capital in the form of Stock-in-Trade, Work in Progress, and Book Debts which its expanding business has called for. It has been able to do this because its depreciation fund, which has gradually grown during the ten years to £48,000, has been invested in its business.

In the example quoted above it has been assumed that all the new Plant and Machinery purchased during the ten years has been additional to the Plant originally purchased at the inception of the Company-in other words, that none of it represents Plant purchased to replace any of the original Plant which may, from any cause, have become useless. But the point is to be noted that, in due course the Plant originally boughtand, in fact, all the Plant, whenever bought-will in time, by reason of wear and tear, and possibly also of obsolescence, become of no economic value to the business and will have to be scrapped. When that time comes such Plant will presumably have to be replaced by new Plant in order that the business may be properly equipped to continue its output on the same level as in the past.

Let it be presumed that in a particular year (subsequent to the ten-year period referred to above) a certain quantity of the Company's plant does become worn out and incapable of being used economically in the business; and let it be assumed that at that particular time trade is slack and that for the time being the plant is not replaced, as the Company is not receiving more orders for its product than are sufficient to keep the remainder of its plant fully occupied.

Clearly the Company cannot continue to include on the Assets side of its Balance Sheet Plant which has, for all economic purposes, ceased to exist. And it is for such an anticipated event that the depreciation reserve has been built up. The Company then reduces its depreciation reserve, which stands on the Liabilities side of the Balance Sheet, by the cost of the Plant which has been scrapped, and reduces correspondingly the Asset 'Plant' on the Assets side of the Balance Sheet.

This book-keeping entry does not, of course, mean that there has been a sudden withdrawal from the business of Capital to the extent of the original cost of the Asset which has been scrapped. As a fact, of course, there has been a steady diminution in the value of that Asset by reason of the wear and tear to which it has been subjected in the ordinary course of business throughout the whole period of its life; and this wear and tear has, from an Accountancy point of view, been provided for by the annual appropriations to the reserve for depreciation account.

But if it be assumed that the Plant which has become worthless has forthwith to be replaced by new

Plant, then the position is that liquid resources have to be utilized in the purchase of such new Plant. If, owing to its having used the Capital representing the depreciation reserve in its business generally, the Company does not, at that time, find itself with any large balance at its Bankers, it may experience difficulty in finding means to pay for the new Plant needed to replace the old Plant. In deciding, therefore, what the policy of a Company shall be as regards the provision for depreciation of Fixed Assets, the Directors have not only to consider what should be the basis of calculating the amount to be charged in each year's Profit and Loss Account, but also what steps should be taken to render it reasonably certain that when the Fixed Assets, in respect of which the provision for depreciation has been made, fall into disuse and have to be replaced, there will be the necessary liquid resources available for the purpose.

In some cases this situation is protected by the investment of a sum equivalent to the whole or a substantial portion of the balance at the credit of the depreciation reserve outside the Company's business altogether, as, for example, by the purchasing of Stock Exchange securities. When, therefore, the Assets in respect of which the depreciation has been provided become of no value and have to be replaced, the Stock Exchange investments can be sold and the proceeds used for that purpose.

No hard and fast rules can be laid down as to what ought or ought not to be done: the question is one of policy: and, even where a general policy has been decided upon which appears at the time to be advantageous, circumstances may arise in later years which may render it advisable to modify it, or even to depart from it altogether.

If a case could be conceived where all the Fixed Assets of a business which were subject to depreciation were expected to fall into disuse at or about the same time, this circumstance would clearly constitute a very strong argument in favour of investing outside the business a sum equal to the depreciation reserve, thus ensuring that the necessary cash could be made available for purchasing the new Fixed Assets destined to replace those which are to become worn out. But in practice, in the great majority of cases, no such circumstance can, humanly speaking, occur. The various Fixed Assets owned by a Company have different economic lives; and, further, they have not, as a rule, come into existence at one and the same time, but at different times. Consequently their economic lives do not cease at the same moment, but at various times; and, therefore, the purchase of Assets to replace them does not fall to be made at one time, but gradually, over a period. And, concurrently, as new Assets are bought, provision for their depreciation begins to be made, thus making liquid resources available. There are thus two processes going on at the same time, the one tending to counteract the other so far as the effect on the provision of liquid resources is concerned—namely, the provision of depreciation in respect of Assets in existence and use, involving the rendering available of fresh liquid resources, and the purchase of Fixed Assets to

replace those worn out, involving the depletion of liquid resources.

In the Balance Sheet last set out in this chapter it will be seen that the accumulated depreciation reserve in respect of Fixed Assets amounts to £48,000, whereas there is only £8,000 at the Bank to pay for any new Assets which may shortly be required to replace Assets which will have become worn out. But it may very well be found to be the case, if the circumstances are looked into, that none of the Plant is expected to wear out for, say, the next four years, and that even then the amount wearing out and requiring to be replaced is not expected to average during, say, the subsequent six years more than about £5,000 per annum. Let it be assumed that the business keeps on an even keel during the whole of the ten years in question (in other words, that it does not expand or contract), and that the proper provision for depreciation is at the rate of £5,000 per annum. If no replacements of Plant were called for during the whole of that time, the liquid resources of the business would be increased by no less than £,50,000, and such sum would be represented by surplus cash at the Bank, as the business, not expanding, would not need to spend it on the purchase of additional Plant, nor would it be merged in additional Stock-in-Trade, Work in Progress, or Book Debts, as these Floating Assets would remain at the same level as before. But let it be assumed that during the last six of the ten years actual replacements of Plant have to be effected at the rate of about £5,000 per annum. These, in the six years, would require £30,000, which

would reduce the £50,000 surplus cash at Bank referred to above to £20,000. Therefore, at the end of the ten years the business would be in no visible danger of being under-equipped with liquid resources.

A class of provision which has some features in common with those of a provision for depreciation is what is known as a 'Sinking Fund' provision. Such a provision is made annually by means of a charge to Profit and Loss Account.

Sinking Fund provisions may be made for a variety of purposes; one of the most common is the redemption of Debenture debt. In order to make an issue of Debentures more attractive to the investor, it is not infrequently stipulated that the Debentures shall be gradually redeemed over a series of years by means of a Sinking Fund provided by annual charges to Profit and Loss Account. The effect of the gradual redemption of the Debentures is, of course, to enhance the security for the Debentures still outstanding; and it is not uncommon to provide that Debentures are redeemable at some price in excess of the price at which they are issued, so that the holders can then look forward to some bonus on redemption. It would, in an ordinary case, be impracticable to arrange that a Debenture debt should be gradually reduced by any means other than applying a portion of the annual profits for that purpose, because so to do would be equivalent to denuding the business year by year of more and more Floating Capital, until a point might be reached when the undertaking had insufficient liquid resources to

enable it to continue its operations. But, as explained in an earlier part of this book, the earning of profits means that additional net Assets are produced, and to the extent to which profits are not distributed in Dividend such additional Assets remain in the business. To make a charge in arriving at the annual profit, therefore, in respect of a Debenture Sinking Fund, is equivalent to appropriating a certain amount of these additional Assets, thus providing means for repaying an equivalent portion of the Debenture debt.

The following pro forma Balance Sheet illustrates the operation of a Debenture Sinking Fund on the lines described above:

| BALANCE SHEET AT 1 | DATE OF (| Creation of | DEBEN | TURE | Debt |
|-----------------------|-----------|--------------|----------|------|----------|
| Share Capital | €200,000 | Fixed Assets | | | £75,000 |
| 5% Debentures redeem- | | Floating . | Assets | less | |
| able by annual Sink- | | Trade Lia | bilities | | 175,000 |
| ing Fund of £1,000 | | | | | |
| per annum | 50,000 | | | | |
| | | | | | |
| | £250,000 | | | : | £250,000 |

Let it be presumed that at the end of the first year the net profits on the Company's operations, after charging interest on the Debentures, amounted to £20,000, and that in accordance with the arrangements made with the Debenture holders the first annual instalment of the Sinking Fund requires to be charged.

The position would then be as summarized below;

| Share Capital £ 5% Debenture Capital | | Fixed Assets Floating Assets | ··· | £75,000 |
|---|---------|---------------------------------|-----|----------|
| Debenture Sinking Fund: amount provided by a charge to Profit and | 50,000 | Trade Liabilities | | 195,000 |
| Loss Account Profit and Loss Account: | 1,000 | | | _ |
| Net profit for the year after charging interest on Debentures but be- | | | | |
| fore charging Deben- ture Sinking Fund | | | | |
| provision £20,000 Less: Amount | | | | |
| carried to Debenture | | | | |
| SinkingFund | | | | |
| Account 1,000 | | | | |
| | 19,000 | | | |
| £ | 270,000 | | : | £270,000 |

It now becomes necessary to utilize an amount equivalent to the Sinking Fund provision, namely, $\mathcal{L}_{1,000}$, in redeeming an equivalent amount of Debentures. This merely means, from the Balance Sheet point of view, that the Debentures are reduced from $\mathcal{L}_{50,000}$ to $\mathcal{L}_{49,000}$, and that a corresponding reduction takes place in the amount of the cash at Bank (which is included in the Floating Assets of the Company) as the cash is utilized to pay off the Debentures.

When this payment has been made the Balance Sheet appears as follows:

| Share Capital Debenture Capital Debenture Sinking Fund | | Fixed Assets Floating Assets Trade Liabilities | less 194,000 |
|--|-----------------|--|-----------------|
| Account Profit and Loss Account | 1,000 19,000 | | |
| | £269,000 | | £269,000 |

The reader may ask, 'Why, if an amount equal to the Debenture Sinking Fund has been applied in redeeming Debentures, can such Fund still appear on the Liabilities side of the Balance Sheet; is there really a Fund or has it been dissipated?' The answer is that the Fund does still, in effect, exist—in other words, it has not been dissipated.

The total net Assets of the Company at the outset were £200,000—namely, the equivalent of the Share Capital—and such Assets consisted of:

| Fixed Assets | Liabilit | ies | £75,000 175,000 |
|----------------------|--------------|-----|--------------------|
| Less: Debenture Debt | •• | •• | £250,000 50,000 |
| | | | £200,000 |

Subsequently these Assets were added to by the amount of the net profits earned, namely £20,000, there therefore being an accretion to the net Assets to that extent. The charge to Profit and Loss Account of £1,000 in respect of Debenture Sinking Fund, and the crediting of this sum to Debenture Sinking Fund Account, clearly does not diminish the funds of the Company; this is a book-keeping entry which does not record a real transaction, but is merely a transfer from one account to another. Nor does the repayment of Debentures totalling £1,000 reduce the net Assets of the Company, because although an Asset—namely cash at Bank—has been reduced by £1,000, a Liability—

namely Debenture Debt—has also been reduced by a corresponding amount.

The net Assets of the Company still remain at £220,000, being composed of:

| Fixed Assets | e Liabili | ities | £75,000 194,000 |
|----------------------|-----------|-------|--------------------|
| Less: Debenture Debt | •• | | £269,000 49,000 |
| | | | £220,000 |

In other words, the Debenture Sinking Fund Account is a free reserve account just as is the balance on Profit and Loss Account, and both these balances are represented by Assets, though no specific Assets can be earmarked to either of them.

In effect the operation of a Debenture Sinking Fund means that each year a larger proportion of the Capital employed in the business is represented by Capital belonging to the Shareholders and a smaller proportion by Capital belonging to Debenture holders. The Debenture debt gradually declines and there is a corresponding growth in the free reserve represented on the Balance Sheet by the Debenture Sinking Fund. The Debenture Sinking Fund is created by the retention of profits which would otherwise be distributed to the Shareholders in dividend. The profits so retained are represented by an accretion to the net assets (that is to say, the assets less liabilities) of the business, and this accretion, instead of taking the form of additional

assets, takes the form of a reduction in liabilities. The assets less liabilities belong to the Shareholders as a body, and the Shareholders' interests in the concern are represented on the Balance Sheet partly by the nominal value of the issued Share Capital and partly by the balances at the credit of accounts such as the General Reserve Account, the Profit and Loss Account and the Debenture Sinking Fund Account.

A Debenture Sinking Fund is usually what is known as cumulative—that is to say, the appropriation made to it each year increases by an amount equivalent to interest on the Debentures redeemed. The charges appearing in the Profit and Loss Account in respect of Debenture interest and Debenture Sinking Fund total to the same amount each year, although as the Debentures gradually become redeemed through the operation of the Sinking Fund the charge for Debenture interest correspondingly declines. Each year, therefore, a smaller portion of the combined charge represents Debenture interest, and a larger portion represents the appropriation to the Debenture Sinking Fund. In consequence of this the amount of Debentures redeemed each year by means of the Sinking Fund increases.

In the case just considered the charge in the first year was as follows:

| In respect of Debenture interest | £2,500 |
|--------------------------------------|------------|
| (namely 5% on £50,000) | |
| In respect of Debenture Sinking Fund | 1,000 |
| | |
| | £3,500 |

If the Sinking Fund in this case was a cumulative one the charge in the second year would be composed as follows:

In respect of Debenture interest ... £2,450 (namely, 5 % on £49,000)

In respect of Debenture Sinking Fund (namely, £1,000 plus an amount equivalent to interest at 5 % on the £1,000 Debentures redeemed at the end of the first

year)

Total, as in the first year £3,500

Two important differences will have been noted in the financial effect of a Depreciation Reserve (or Depreciation Fund, as it is sometimes termed) as compared with the financial effect of a Debenture Sinking Fund.

The first difference is that the gradual growth of a Depreciation Fund is accompanied by a gradual growth in the liquid resources of the business concerned, thus rendering it possible for the business to acquire additional Fixed Assets, if such are necessitated, without denuding itself of reasonable Floating Capital for its needs. The gradual growth of the Debenture Sinking Fund does not, however, make a corresponding increase in the floating resources of the business, as, instead of there being an accretion to the Floating Assets, there is a gradual diminution in the total of a long-term liability—i.e. the Debenture Debt. This

diminution is, of course, an advantage to the business in the long run, as when a Debenture Debt has become extinguished a Company is more favourably situated in regard to borrowing from other sources, as, for example, from Banks. The mere growth of the Debenture Sinking Fund does not, however, as explained above, provide the Company with the resources out of which to extend its operations.

The second important difference in the financial effect of a Depreciation Fund as compared with the financial effect of a Debenture Sinking Fund, is that the business obtains, in respect of a Depreciation Fund, an indirect benefit which grows as the total of the fund increases. This occurs by reason of the fact that the fund is represented by Assets which are in use in the business and are presumably Revenue producing; and the larger the amount of such Assets the greater presumably is the revenue produced by the use of them. The Debenture Sinking Fund does not by its growth place any more Assets at the disposal of the business; it does, it is true, cause a Liability (i.e. the Debenture Debt) to be gradually reduced, and the charge for Debenture interest becomes, in consequence, less every year. But, as will be remembered, the Sinking Fund is cumulative, and an amount equal to the interest on the Debentures redeemed has to be provided each year, so that the total charge against the Company's Profit and Loss Account (i.e. for Debenture interest and Debenture Sinking Fund combined) is not lessened.

While the most common form of Sinking Fund is that which is attached to a Debenture issue, Sinking

Funds are not infrequently created for quite other purposes.

For example, a Company may carry on its business in leasehold premises having a certain fixed term to run, and a substantial premium may have been paid for the lease.

The Company therefore has in its Balance Sheet an Asset (namely, the premium paid for the lease) which, at the expiration of a known term of years, will have no value. On economic grounds, therefore, it is desirable to write off or provide for this premium out of profits over the period of the lease; and not improbably it may also be desirable to invest outside the business amounts equal to the annual charge to Profit and Loss Account in respect of depreciation of the leasehold interest, in order that when the term of the lease has expired the Company may have in its possession Stock Exchange securities which can be realized on the market, and the proceeds of which would enable it to purchase premises elsewhere or to obtain, by the payment of a premium, a renewal of the lease of its existing premises for a further term of years.

In calculating what the annual charge to Profit and Loss Account should be, the Company will, of course, take into account the fact that the income arising from the investment of the fund is added each year to the fund. All that is required is that the aggregate of the sums charged annually to Profit and Loss Account and the income received from the investment of the fund should accumulate to the amount which the leasehold interest has cost by the time that the lease has expired.

An alternative method of accumulating the necessary funds would, of course, be to take out an Insurance policy, the annual premium on such policy being equivalent to the amount of the annual Sinking Fund provision. In either event the provision would be what is known as a cumulative one, because, in the event of the Company investing the annual provision in Stock Exchange securities, the income from such securities would be added to the Sinking Fund and invested, while in the event of the Company taking out an Insurance policy the same process would in effect occur (though not visibly), as the Insurance Company, in calculating what the annual premium should be, takes account of the fact that the premiums remain in its hands for a lengthy period and are invested and so earn interest.

The following pro forma Balance Sheet illustrates the operations of a Sinking Fund for the redemption of a lease:

Share Capital ... £16,000 Cost of leasehold premises £10,000 Floating Assets ... \$8,000 full testing Assets ... \$18,000 full testing Assets ... \$10,000 full testing Assets ... \$10,00

Let it be assumed that, if £500 per annum is set aside annually, this, together with compound interest at the rate of 4 per cent. net, will enable the £10,000 paid for

THE BALANCE SHEET

the lease to be written off by the date when the term of the lease will have expired.

If the necessary provision for the first year is made the Balance Sheet would appear as follows:

| Share Capital Leasehold Sinking Fund | £16,000 | Cost of leasehold premises | £10,000 |
|---|---------|----------------------------|---------|
| Account Balance on Profit and Loss Account after providing for lease- | 500 | Floating Assets | |
| hold Sinking Fund | 1,500 | | |
| | £18,000 | | £18,000 |

Up to this stage no attempt has been made to invest outside the Company's business an amount equivalent to the sum at the credit of the leasehold Sinking Fund Account. This step, however, is necessary if, at the termination of the lease, the Company is to be assured of having, in liquid securities not required for the ordinary purposes of its business, the sum of £10,000 to enable it to purchase a new leasehold interest.

When the necessary investment is made the Balance Sheet will appear thus:

| Share Capital Leasehold Sinking Fund Account Balance on Profit and Loss Account after providing for leasehold Sinking Fund | | Cost of leasehold premises | £10,000 500 |
|--|---------|----------------------------|----------------|
| - | £18,000 | | £18,000 |

The position at the end of the next year would be that there would be added to the leasehold Sinking Fund Account a further £500 (representing the annual sum chargeable to Profit and Loss Account) plus the income received during the year from the first £,500 which was invested at the beginning of such year. If it could be assumed that this interest amounted to f_{120} , the leasehold Sinking Fund would stand in the Balance Sheet at £1,020; and further investments in Stock Exchange securities would be made at that time of £520, namely in respect of the second year's fixed charge to Profit and Loss Account of £500 and in respect of the £20 interest received on the first £500 invested. Consequently the total investments in respect of the leasehold Sinking Fund would then appear on the Assets side of the Balance Sheet at £1,020. The Balance Sheet would then appear somewhat as follows:

| Leasehold Sinking Fund Account Balance on Profit and | | Cost of leasehold premises | £10,000 |
|---|------------------|--|---------|
| Loss Account after providing for leasehold Sinking Fund | 1,500 £18,520 | Exchange securities in respect of leasehold Sinking Fund | 1,020 |

When the period of the Sinking Fund had ended, the fund would appear on the Liabilities side of the Balance Sheet at £10,000, and there would appear on the Assets side of the Balance Sheet Stock Exchange securities of an assumed value of £10,000.

The old lease, then, having expired, its cost, namely £10,000, would be deleted from the Assets side of the Balance Sheet and the Sinking Fund balance of £10,000 would be deleted from the Liabilities side.

If a new lease were then bought, the Stock Exchange securities would be sold for £10,000 and the cash proceeds would be used to purchase or assist in purchasing the new leasehold interest. In other words, the Stock Exchange securities would disappear from the Balance Sheet, and in their place would appear the new leasehold interest.

It is instructive to note the difference between the financial effect of

- (a) The Sinking Fund to redeem Debentures, and
- (b) the Sinking Fund to write off the cost of a leasehold interest.

In the case of the Sinking Fund to redeem Debentures there is a gradual accretion to the net Assets (i.e. the Assets less Liabilities) of the business, because, as already explained, the charging against Profit and Loss Account of the annual Sinking Fund provision means that to that extent the additional Assets, which represent the profits earned, are retained in the business. The amount of the net Assets is not reduced by the repayment of a portion of the Debenture Debt each year, as this simply means that, while an Asset (Cash at Bank) has been reduced, a Liability (Debenture Debt) has been reduced to an exactly equivalent extent.

In the case of the Sinking Fund to write off the cost of

a lease, however, while the charging of this Sinking Fund provision to Profit and Loss Account does mean that additional Assets, representing a portion of the annual working profits earned, are retained each year in the business, simultaneously the Asset of leasehold property appearing on the Balance Sheet becomes less valuable as the date of termination of the lease draws nearer.

Summarizing the position, therefore, the financial effect of the Sinking Fund to redeem Debentures is that there is an accretion to the net Assets of the business, whereas in the case of the Sinking Fund to write off the cost of a leasehold interest there is no accretion to the net Assets of the business.

There are a number of items which are not uncommonly found in Balance Sheets—some on the Assets side and others on the Liabilities side—in regard to which no comments have yet been made in this chapter, and brief reference to these seems called for.

On the Liabilities side there are to be found—often included under the general head of 'Sundry Creditors'—reserves for outstanding expenses or accrued charges. In the sense that these items do not represent Liabilities immediately payable, the correctness of their inclusion under the heading of creditors may be queried. But from the point of view of a correct Balance Sheet they are equivalent to creditors. For example, a Company whose Balance Sheet is drawn up each year on 30th September may be the tenant of some premises in respect of which the rent is payable half-yearly on

goth June and 31st December. It would clearly be incorrect if the Company, in drawing up its Accounts as at 30th September, ignored the fact that there was at that date three months' rent accrued. Obviously the only proper course for the Company to adopt is to include the accrued rent as part of its expenses for the year to the date of the Balance Sheet (in other words, to debit it to the Profit and Loss Account of the year) and to hold the item up as the equivalent of a Liability on its Balance Sheet. If it failed to do this it would be producing a Profit and Loss Account which, in effect, contained on the credit side the whole of the benefit arising from the use of the premises for the year, but which only included as a charge on the debit side nine months' rent in respect of those premises.

The above is a case where the exact amount of an accrued expense can be ascertained and dealt with in the Accounts. There are, however, cases where the exact amount of an outstanding expense or accrued charge is unknown; and where the necessary reserve in respect of it can only form the subject of an estimate. Under such a category would fall a reserve for Income Tax, where the assessment had not yet been agreed with the Inland Revenue Authorities. Another example of a similar character would be a reserve in respect of damages and costs in a legal action pending against the Company.

On the Assets side of the Balance Sheet would be included (frequently under some such heading as 'Sundry Debtors, etc.') what are known as 'prepaid charges' or 'payments in advance.' These items do not

represent debtors in the sense that they are not to be realized in cash. They represent disbursements which are proper charges in arriving at the profits of a period subsequent to the date of the Balance Sheet. For example, a Company pays its Fire Insurance premiums in respect of its buildings, etc., in advance. Obviously only that portion of any payment made in a financial year which is attributable to that financial year forms a proper charge in arriving at the profits of such year: the balance, relating to the subsequent year, is properly held up on the Assets side of the Balance Sheet, to be charged in arriving at the profits of the subsequent year.

There are certain items found on the Assets side of Balance Sheets which, though of a Capital nature, are fictitious rather than real Assets. Such items include Capital duty on the formation of a Company and legal and other expenses incidental to the formation: expenses of issuing and advertising a Prospectus; underwriting and other commissions in connection with the subscription of Share Capital; discounts on the issue of Debenture Capital. Such items have no value in themselves, though they form part of the legitimate cost of forming the Company and issuing its Capital. The usual practice, if the Company's profits permit, is to write these items off by appropriations of profits, either at once or over a series of years, in order that the Balance Sheet may in due course contain on the Assets side no items which are not Assets of real value.

Reference was made at the commencement of this chapter to the fact that the Balance Sheets of some

Public Companies are subject to criticism from the point of view that they are presented in too abbreviated a form. Allusion was also made to the fact that it is not always appreciated that Balance Sheets are, in their essence, subject to certain limitations.

In Appendix G will be found:

- (a) A specimen of a Company's Balance Sheet in an abbreviated form,
- (b) the same Balance Sheet re-drafted in order to afford much fuller information, and
- (c) certain notes indicating the limitations to which the Balance Sheet is subject.

With the object of assisting the reader to criticize Balance Sheets, two further Appendices have been prepared.

Appendix H contains two pro forma Balance Sheets, one exhibiting considerable strength and the other considerable weakness: and appended to each Balance Sheet are notes pointing out the salient features.

Appendix I shows a comparison of the pro forma Balance Sheets of two Companies over a series of years, the Balance Sheets of one Company showing increasing strength from year to year and the Balance Sheets of the other Company increasing weakness. Notes are appended to each group of Balance Sheets calling attention to the changes in financial position which are apparent on a review of the figures.

The foregoing Chapter is mainly confined to an outline of the general principles upon which the

Balance Sheet of a Public Limited Company is drawn up and a description of the meaning of the various items appearing in such Balance Sheet. As already mentioned in Chapter VI, the Companies Act contains certain stipulations in regard to the keeping of Accounts and the form of the Balance Sheet; and it has been thought more convenient to summarize these in a separate Appendix (Appendix F).

CHAPTER VIII

AUDITORS OF A PUBLIC COMPANY

Every Public Company must have an Auditor or Auditors.

While there are certain classes of person who cannot be appointed Auditors to a Company (as, for example, a Director of the Company), there are no special qualifications which an Auditor is required by law to have. In other words a person possessing no experience whatever of Accounts can be appointed an Auditor to a Public Company. A Company may, however, under its Articles of Association, define the qualifications of, or limit the class of person who can be appointed as, its Auditor. In the very great majority of cases, however, the Auditors to Public Companies are qualified Accountants—usually Chartered Accountants.

Broadly speaking, it may be said that Auditors are appointed and their remuneration fixed by the Shareholders of the Company on the occasion of each Annual Meeting, and that they hold office until the next Annual Meeting. The first Auditors to the Company may be appointed by the Directors prior to the first Annual General Meeting, but the continuance of such an appointment is subject to the subsequent approval of the Shareholders. No one except the retiring Auditor can

be appointed at an Annual Meeting unless certain notices have been given in advance.

The Auditors have a right of access at all times to the books, accounts, and vouchers of the Company, and are entitled to receive from the Directors and other officials such information and explanations as may be necessary for the performance of their duties. The Auditors are required to make a report to the Shareholders on the Accounts examined by them, and on every Balance Sheet laid before the Company in General Meeting. In such report they are to state:

- (a) Whether or not they have obtained all the information and explanations they have required, and
- (b) Whether in their opinion the Balance Sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the Company.

The Auditors are entitled to attend any General Meeting at which Accounts which have been examined or reported upon by them are to be submitted; and they are entitled to make, at such Meeting, any statement or explanation they may desire with respect to such Accounts.

From what has been said above, and from the comments contained in Chapter V on the Administration of a Public Company, in Chapter VII on the Balance Sheet of a Public Company, and in Appendix F, in regard to the form in which the Balance Sheet must be presented, it will be appreciated that:

- (a) The Auditors are the servants of the Shareholders, and not of the Directors;
- (b) The Balance Sheet is the production, not of the Auditors, but of the Directors, and that the Auditors have no power to alter it, but merely the right to comment upon it in their report;
- (c) The Companies Act contains certain stipulations as to the information which must appear in the Balance Sheet; and that it will be the duty of the Auditors to ascertain whether such stipulations have been complied with, and if they have not been complied with to refer to the matter in their report to the Shareholders.
- (d) Except to the limited extent to which the provisions of the Act afford a guide, there is no statutory definition as to what an 'audit' of a Company's Balance Sheet is expected to comprise, nor as to what constitutes a Balance Sheet which is 'properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs.' These matters are very rightly left to be determined by the interested parties in the light of the particular circumstances of each individual case, and the Legislature carefully abstains from any attempt to draw up hard and fast rules.

It is to be observed that what is commonly referred to as an Auditor's 'unqualified certificate' (or, to use another common expression, 'clean certificate') on a Balance Sheet is really a certificate of a limited character. The Auditor does not, for example, state that the

Balance Sheet is properly drawn up; but merely states that in his opinion it is properly drawn up. And the significance of the words 'in his opinion' will be appreciated in the light of the words which come later in the certificate—i.e. 'according to the best of his information and the explanations given to him, and as shown by the books of the Company.' These words clearly indicate that the opinion to be given is not, for example, the opinion of a man who has, so to speak, lived with the Company's business or taken any active or continuous part in the management thereof. It is the opinion of a man who inspects at a certain time or times in the year the books of account and other evidence supporting the entries in the books, and who calls upon those in charge of the business for information or explanations on any matters which he thinks may be of value from the point of view of confirming or disproving the correctness of any item in the Balance Sheet upon which he is required to report as Auditor.

For example, it is conceivable that transactions on a Company's behalf may have been entered into by the management, but may never have found their way into the books of account at all. In such circumstances an Auditor might be left in complete ignorance of such transactions, and might be under no responsibility whatever if he certified a Balance Sheet as being in his opinion properly drawn up which failed to incorporate them.

An audit does not comprise the checking of every entry in the Company's books of account. In wellregulated businesses of substantial size automatic means

are provided for ensuring that the book entries are correct. For example, various sections of the books are made to balance independently of each other. Again, members of a Company's own accountancy staff check each other's work; further, by statistical and other means, checks or tests are imposed on the various figures. Arrangements of this character are known collectively by the term 'internal financial control,' or 'internal check.' The Auditor who has to certify a Balance Sheet relating to a business where such safeguards are in operation would review the position generally and enquire what the system was; he would then decide as to the extent to which it was necessary for him to check or test the records in order to be reasonably satisfied that the Balance Sheet was correctly drawn up.

In cases which have come before the Courts where an Auditor's functions and duties were under consideration, the Judges have expressed the view that Auditors are watchdogs and not bloodhounds; that in proper circumstances they are not to be held responsible for tracking down deeply laid schemes whereunder Accounts have been falsified; that they are entitled to place reliance on the explanations given them and the views expressed by trusted officials of the Company, and, in the absence of suspicious circumstances, to accept as correct the information so given them; that they are entitled to rely on the efficacy of properly devised systems of internal control which may be in operation; and that in proper cases their duty is covered by testing at random the correctness of certain

classes of book entries and assuming that the similar entries not checked by them are correct.

On the other hand, Auditors are expected to exercise due skill and care commensurate with the importance and responsibility of their office; they are expected to be especially critical in their outlook and exacting in their requirements where suspicious circumstances are present; and they must not certify anything as true and correct unless they honestly believe it to be so.

CHAPTER IX

PROSPECTUSES

The Companies Act contains a number of provisions with which Prospectuses—that is to say documents offering Shares or Debentures in Companies for public subscription—must comply. A description of these provisions does not fall within the scope of this book. They have as their object, it is true, the protection of the investing public; but they are matters with which the investor need not be familiar. When a Prospectus appears it is naturally assumed by the investor that those responsible for its issue have taken due steps to ensure that the law has been complied with.

The observations in this chapter are confined to certain matters which are of interest to the investor who has occasion to peruse Prospectuses in the sense that they may be helpful to him in forming conclusions as to the attractiveness or otherwise of the securities which are offered for subscription.

In the first place, a few comments on the functions of those who make it their business to arrange or assist the issue of a Company's securities to the public seem called for. These functions are commonly undertaken by what are known as 'Finance Houses' or 'Issuing Houses.'

There is nothing to prevent a public Company from issuing a Prospectus inviting the public to subscribe for

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its Shares and Debentures without utilizing the services of an Issuing House or making contracts with any parties to underwrite the issue—in other words, to undertake for a commission to subscribe for such portion of the issue as the public may fail to take up. For example, Directors of old-established public Companies owning stable and successful businesses which require from the public additional Capital may feel so confident of their ability to obtain it (largely, possibly, from their own Shareholders), that they may decide to dispense with the services of any Financial Institution and dispense also with underwriting; such cases are, however, relatively few.

Broadly speaking, Prospectuses relating to Capital issues of public Companies fall under two categories. The first class of Prospectus is that where the Company itself makes the issue to the public; and the second class is where some other party has purchased the whole issue, either from the Company or from someone else, and is offering it to the public, presumably at a profit to himself. Prospectuses of the latter category are known as 'offers for sale.' Prior to the coming into operation of the Companies Act, 1929, there was very considerable information which was not required by law to be furnished in the document constituting an 'offer for sale,' but which had to be disclosed in cases where the Company itself offered the security. Now, however, similar information has to be disclosed in both classes of document, except that under certain special circumstances, defined in the Companies Act, less information is required to be furnished.

The functions of a Finance House or Issuing House in connection with a Prospectus may, then, largely be confined to the underwriting of the issue, or they may extend to the purchase of the issue *en bloc* from the Company, or from some third party, and its re-sale to the public at a profit.

The investing public are startled from time to time by grave scandals which come to light in connection with Company flotations; and it is hardly to be wondered at that in the minds of some investors Finance Houses, Issuing Houses, and the like represent unscrupulous sharks who are wont to receive for their services much more than is warranted, who are accustomed to father issues the merits of which are not only doubtful, but unfairly presented, and who therefore may be said to batten on the public. While there have been in the past, and no doubt will be in the future, individuals and institutions of which this could not unfairly be said, such a suggestion, if applied to houses of good repute engaged in this class of business, is quite unwarranted.

An Issuing House, if it performs its duty properly, plays a more important part in connection with an issue to the public of securities in a Limited Company than do the other classes of expert—Solicitors, Accountants, Valuers, and others—whose services are, or may be, required. And, in regard to remuneration, it must be remembered that competition is present in the realms of high finance no less than in other walks of business life, and that this of itself affords a corrective in the sense that it ensures in an ordinary case that no

exorbitant charge for services rendered can be made, or exorbitant profit earned on the purchase of Share or Debenture Capital *en bloc* and its sale to the public. There is no 'combine' or 'ring' among the Finance or Issuing Houses of the City of London; in fact, there is keen rivalry between them.

Furthermore, a very noticeable feature which will be apparent to anyone who has had any close experience of the methods of Finance and Issuing Houses is the extreme care and caution exercised by Houses of high standing in considering and accepting business which they are afforded the opportunity of carrying through. It is not considered sufficient by a first-class Issuing House merely to succeed in pocketing an underwriting commission by reason of an issue which it has sponsored being taken up in full by the public, or in realizing a profit on the purchase of securities and their re-sale to the public. The high-class Issuing House goes further than this; it is anxious that the businesses or undertakings which it has been instrumental in placing under the sole or partial ownership of the investing public should be sound, and that the sequel should prove that the public has obtained a satisfactory investment. brief, the Issuing House has a high conception of its responsibilities towards the investor, and it is anxious to ensure, so far as practicable, that its name should only be associated with sound and respectable undertakings, and that the terms on which the investor is invited to take an interest in these are fair.

The management of an Issuing House with uniform success over a series of years, and the preservation of the

PROSPECTUSES

reputation of that House, call, in a high degree, for skill, judgment, and foresight, to say nothing of integrity. Judgment and foresight are, in a measure, heaven-sent gifts, and skill is usually only born of hard work and lengthy experience. And the labourer is worthy of his hire.

Every occupation or profession has, of course, its black sheep; and Finance and Issuing Houses are no exceptions to the rule. An Issuing House lacking in moral sense and by no means over-careful for its reputation may not infrequently be tempted to undertake business highly profitable (and possibly risky) to itself, but detrimental to some other party—probably the investing public.

In times when much Stock Exchange activity prevails and prices of stocks generally are rising, opportunities for public flotations are exceptionally favourable. These opportunities are seized with avidity by not too scrupulous Finance Houses and others to sell securities (possibly of very doubtful worth) to the public at inflated prices, the public being, at such times, infected with the general optimism prevailing on the Stock Exchanges, and therefore specially gullible. Or it may be that a particular industry, for some special reason, has been enjoying a period of exceptional prosperity; and advantage may be taken of this to sell concerns engaged in that industry to the public at prices based not on normal, but on abnormal earning capacity.

There are, of course, many means whereby an issue of Shares can be made, on the face of it, to appear more

attractive in a Prospectus than it really is. Persons having high-sounding titles (but with limited financial or business experience) may be advertised as appearing on the Directorate. If the business in question is an established one its good points and its prospects can be referred to in exaggerated language. If, on the other hand, the enterprise is a new one, comparisons (often illusory) can be drawn between it and some enterprise of similar character which happens to have been exceptionally successful, or optimistic calculations can be made of its future earning capacity, supported in part by reports of technical experts whose experience may not be great, or whose reputation may not stand very high.

In view of the character or terms of the issue an exceptionally high rate of underwriting commission will probably have to be paid; and the underwriters in their turn may make it a stipulation that an extensive campaign for advertising and circulating the Prospectus is embarked upon. All these expenses are not improbably borne by the investing public—indirectly if not directly. These matters, however, appear relatively unimportant to the man in the street, in whose eyes the extravagant forecasts of future profits—frequently printed in bold type—are apt to loom large, blinding him to everything else.

If investors paid more attention to the name of the Finance or Issuing House under whose ægis the securities of a Company are offered to the public, they would make far fewer bad investments. If the Investor does not know the standing of an Issuing House making any

particular issue, an enquiry of his Bank will soon produce the necessary information. And it is submitted that the matter is of no less importance to the Company itself. 'Safety First'—admirable as a road traffic text, but disappointing as a political slogan—is still, as recent events in the City of London have demonstrated, the best motto when it comes to the question of the choice of an Issuing House by those desiring to place issues of Stocks, Shares, or Debentures on the market.

Bearing in mind the particular objects with which this book has been written, it is thought that this chapter on Prospectuses may most appropriately be concluded by giving a list of various points to which an investor who scrutinizes a Prospectus offering the Shares or Debentures of a Public Company, should or may require to consider.

Personnel

What are the qualifications and reputations of the men comprising the Board of Directors? Of what other Company, or Companies, is each of them a Director, and what is the standing of such Company?

What is the standing of the Finance or Issuing House which is concerned in the issue?

What is the experience and standing of any technical experts whose report is published in the Prospectus, such, for example, as Valuers?

What is the standing of other parties whose names may appear on the Prospectus in various capacities—i.e. Solicitors, Stockbrokers, Auditors?

WHERE THE ENTERPRISE CONSISTS OF AN ESTABLISHED GOING CONCERN

- Has the business been uniformly successful over a fairly long series of past years; and, if it has not, what are the causes to which temporary non-success is attributed, and are such causes likely to recur?
- Is the business carried on in this country or abroad; if it is carried on abroad, what are the special risks to which it may be subject, including risks arising by reason of political disturbances?
- Is the business of a class or character in which competition is very keen, and, if so, what are the general tendencies in this connection?
- Is the business engaged in the manufacture or distribution of what may be called necessities, or of luxuries?
- Does the business deal with goods the demand for which may vary by reason of changes in the public taste or fashion, or which may be vitally affected by new inventions?
- Does the business deal with goods of a special kind, or is it concerned with a large variety of classes of goods?
- Is the value of the business largely dependent upon the ownership of certain patents or similar rights, and, if so, what are the future probabilities or possibilities in this respect?
- Does the business have, by reason of its geographical situation, or from other causes, a monopoly or semi-monopoly which would render it specially immune from competition?
- Does the business largely depend upon the continued supply of any one particular commodity or class of commodity, or upon the continuation of good relations with one supplier?

- Has the business among its customers one or two who are so important that the loss of their custom might be serious?
- Is the business largely dependent, as regards its sales, on the continued prosperity of any other particular business or class of business?
- Does the business sell its products mainly to customers in this country or abroad; and, if the latter, are the sales spread over a large number of foreign countries or are they confined to a few only, in which latter case political changes in those countries might have a serious effect (e.g. wars, imposition of import duties)?
- Is the business of a class which might in future be specially prejudiced (or, alternatively, which might be benefited) by any alterations in fiscal arrangements in England (e.g. removal of, or extensions in, the range or scale of the safeguarding duties)?
- Has the business largely depended in the past for its success on the efforts or personality of one or two men; and is the future safeguarded in this connection (as, for example, by service agreements) so far as is practicable?
- Is the business one which is very materially affected by the state of trade generally in this country?
- How is the value placed upon the business composed? In other words, to what extent is such value covered by what may be called 'tangible' assets, and to what degree is it represented by intangible assets such as Goodwill, Patent Rights, Trade Marks? In regard to the tangible assets, to what extent, if the business fell upon evil days, would these be worth something approaching their book value by reason of the fact that they could be used profitably elsewhere, or for other purposes?

Does the value placed upon the business seem a fair one

when judged in the light of earning capacity? If a statement of the profits earned in each of a series of past years is set out in the Prospectus, what is the general trend of these profits—that is to say, do they tend to rise or to fall? Also, do they vary very much as between one year and another, and, if so, to what are the variations attributable?

Has the dividend policy in the past been conservative or the reverse?

Is any reason given for floating as a Company, and, if so, is it a good one? *Prima facie* the owner of a business with very good prospects would not be anxious to sell it except at a very high price.

WHERE THE ENTERPRISE IS A NEW ONE

What special qualifications are stated to be possessed by the party or parties who will be put in charge of the management of the business? Is there any evidence tending to prove the possession of these qualifications?

Will the enterprise be protected by patents, concessions, or similar rights, or will it for any reason (such as geographical situation) have something tantamount to a monopoly or something which places it in a preferential position vis-d-vis competing enterprises?

If estimates of future earnings appear in the Prospectus, by whom have these estimates been compiled and on what basis? Do they appear reasonable and have they been carefully worked out, or are they more in the nature of guesses or hopes?

Has adequate provision been made for Capital which will require to be available in order to bring the enterprise to fruition?

- Similar questions arise as in the case of the established undertaking, in regard to the country where the enterprise is situated, the nature of the services which the concern is to render, or the commodities with which it is to deal, and also in regard to the suppliers and customers with which it will be concerned.
- It may be taken as fairly certain that the investor in a new business is taking more risk than when he invests in a business with a good past history and profit record. All estimates, whether of Capital required or profit to be made, should therefore be scrutinized most carefully.

THE VENDOR

- Is the Company itself making the issue? If it is not, who are the Vendors; for what purpose are they selling; and how long have they been the owners of the Assets of which they are seeking to dispose?
- What net profit are the Vendors making for themselves in connection with the sale, and does the amount of such net profit seem, under all the circumstances, to be a reasonable one?
- In what form are the Vendors taking their profit on the transaction—in cash or in securities?
- If the Vendors are taking their profit in securities, how do such securities rank both for Income and for Capital as compared with the security or securities which are being offered to the public?
- If the Company itself is making the issue, for what purpose are the proceeds of the issue required? Are they to enable a business or undertaking to be paid for by the Company, and, if so, does the purchase price seem

to be a fair one? Who were the previous owners of the business, and what is their object in selling it to the Company? Are such owners being paid in securities or in cash, or partly in one form and partly in another? If they are being paid partly in securities, how do the securities rank for Capital and also for dividend as compared with those for which the public is being asked to subscribe?

In this connection an Investor should calculate what proportion of the risk and what proportion of the profit and what proportion of the voting power the Vendor is getting as compared with the public, and should consider whether it seems a fair one. If an Investor does not feel capable of doing this or if the necessary information is not given, he should avoid investing in the Company.

Were the Vendors actively concerned in the management of the business which they are selling to the Company? If so, will they continue in that capacity under agreements with the Company, or, if not, does the Company consider that the business can be administered effectively without their services? In the latter event, are the Vendors in a position to enter another business and compete with the Company, or have they given effective undertakings not to do so?

In cases where Prospectuses contain forecasts of future profits which are considerably higher than would be presumed from a consideration of past results, and which show a high return on the purchase price of the business, the enquiry is prompted as to why the Vendors are willing to dispose of a business which they anticipate will be so profitable at the price named in the Prospectus.

EXPENSES INCIDENTAL TO THE ISSUE

These expenses would, or might, include Capital duty on creation of Share or Debenture Capital; stamp duty in connection with the transfer of Assets; underwriting commission; brokerage paid to Stockbroking and similar firms who induce their clients to subscribe for the securities issued; Valuers' fees for valuation of properties; Solicitors' fees for the drawing up of agreements, etc.; Accountants' charges for certifying the past profits of the business; expenses incidental to obtaining in due course a Stock Exchange quotation for the securities; expense of printing, circulating, and advertising the Prospectus.

Does the Company bear these expenses in whole or in part, or are any of them to be paid for by promoters or others out of the profit or commission receivable by them in connection with the issue?

Has the issue been underwritten, and does the rate of the underwriting commission appear, under the circumstances, to be a reasonable one? A similar question applies to the rate of brokerage.

Do the expenses of the issue, taken as a whole, seem large in relation to the amount of the issue?

RIGHTS OF THE SECURITY OFFERED TO THE PUBLIC

If the Company whose Shares or Debentures are the subject of the Prospectus has more than one class of Capital, what are the exact rights of each of the various classes of Capital—i.e.

- (a) as to Income,
- (b) as to Capital,
- (c) as to voting,

and does it seem as if, bearing in mind its nature, the class of security offered to the public is accorded its fair rights as compared with the other classes of security which may be held by Vendors or other parties? this connection, the observations made elsewhere in this book in regard to Holding Companies and also in regard to Deferred Shares should be borne in mind.

In regard to issues of Debentures, an important point to consider is whether the Debentures are given a fixed charge on certain of the Assets of the Company, and, if so, whether the Assets are of a character which would enable them to command a reasonably high value for purposes other than that of the Company's particular business. If the answer is in the affirmative, this constitutes a safeguard in the event of the Company's business failing and the Assets having to be disposed of piecemeal in order to repay the Debenture holders.

It is also important to observe, in regard to Debentures and Preference Shares carrying fixed rates of interest or dividend, to what extent annual profits cover the income required to pay such interest and dividend—i.e. two, three, four, or more times.

Another important point in connection with Debenture issues is whether a Sinking Fund is to be provided out of profits for the gradual redemption of the Debentures by the Company out of Revenue. Such a Fund ensures-all other things being equal-a gradual improvement in the security for the Debenture holders, both from the Capital and also the Income point of view. A somewhat similar remark applies in regard to redeemable Preference Shares, which, under the Companies Act, 1929, Companies are now entitled to issue.

Another point to be considered, and one which concerns

Debenture and Preference Share issues alike, is the extent to which the Company is empowered to issue in the future further securities ranking pari passu therewith or in priority thereto.

In Appendix J will be found a specimen of a proforma Prospectus, together with certain statements summarizing the financial transactions in connection with the flotation of the business referred to in the Prospectus.

CHAPTER X

COMBINES OWNED OR CONTROLLED BY PUBLIC COMPANIES

There has been a very marked tendency during recent years towards combination among industrial undertakings, as it has been found that in a large proportion of cases an industry can operate more economically and efficiently in large units than in small.

The larger such a unit or entity is, the greater the amount of Capital which it requires; and, such being the case, it is very rare to find nowadays any large Combine in which the public have not a substantial ownership. In other words, Combines are usually owned or controlled by public Companies. For this reason a few observations on the formation and functions of Combines may not be out of place.

What is usually referred to as a 'merger' or 'combine' does not necessarily mean that the businesses concerned have themselves become amalgamated. What a merger does mean or imply is that the interests of the owners of the businesses in question have, in part or in whole, become unified instead of being in conflict with each other.

This unification of interest can be effected in various ways. There may, of course, be an actual merger of the businesses as such. But if such a course is, for any weighty reason, undesirable, the unification can be

brought about by other means. One very common method of merger is that known as the Holding Company method, whereunder a limited Company acquires the whole of, or a controlling interest in, the Share Capital of one or more other Companies owning businesses or undertakings which are desired to be worked in conjunction. The Holding Company may already own a business itself, or it may not. But when once it has obtained the control of businesses owned by other Companies by means of having acquired their Shares, it can, to a considerable degree, operate all the businesses concerned as if they were one, and by this means eliminate losses arising from competition, and secure advantages accruing from co-operation.

The various Companies would, of course, continue as separate entities, and so would the various businesses; there would be no merging of Assets or Liabilities. Methods of operation and management would, however, become uniform, and experience and brain power would be pooled to mutual advantage.

A common circumstance under which a merger is effected by means of a Holding Company scheme is where the Companies owning the various businesses have Debenture or Preference Share Capital issued at what would at the present time be regarded as low rates of interest or fixed Dividend. In consequence of this the Debenture and Preference Shares would stand in the market at prices considerably less than par. If in such a case the business of the Company were acquired with a view to an amalgamation with other businesses the Company would presumably go into

liquidation, and would distribute the purchase price received for its business among its security holders according to their respective rights. In such an event the Debentures would probably have to be paid off at par, or at a premium (according to the terms of the Debenture Trust Deed), and the Preference Shareholders would presumably be paid off at par if such was their right. Thus these two classes of security holders would receive considerably more than the market value of their holdings, and there would therefore be correspondingly less for the Ordinary Shareholders to receive.

If, however, the Purchasing Company, instead of acquiring the business, merely acquired from the individual Shareholders the Ordinary Shares of the Vendor concern (which presumably would carry the voting control), the Debentures and Preference Shares would remain undisturbed; and the price which it would be fair for the purchasing party to give for the Ordinary Shares would be all the higher by reason of the fact that the annual sums payable to the Debenture Holders and Preference Shareholders for the use of their Capital in the business (in other words, the percentage rates of interest and dividend) were relatively low. It will therefore be clear that in cases such as those described above the Ordinary Shareholders of the Vendor Company would be unlikely to agree to the business as such being sold (as this would give an undue benefit to the Debenture Holders and Preference Shareholders, and would correspondingly prejudice the Ordinary Shareholders), though they might

be quite favourably inclined to accept an offer from the purchasing party to acquire their Shares.

Although, as mentioned above, the ordinary effect of a liquidation of a Company incidental to the amalgamation of its business with that of another Company is that Debenture Holders and Preference Shareholders would be paid out on the basis provided in the Debenture Trust Deed and the Articles of Association respectively, yet in appropriate cases other machinery may be put into force to vary it.

For example, as regards Debentures, there is, as a rule, a provision in the Debenture Trust Deed whereby the Debenture Holders can, by an extraordinary resolution (i.e. one carried by a three-fourths majority of votes) agree to modifications in their rights or to the exchange of their Debentures for securities in another Company. It is usually provided in such a case that, if the necessary majority agree, all the Debenture Holders are bound. In the absence of such a stipulation in the Debenture Trust Deed there is a clause in the Companies Act whereunder the Company may make a compromise with its Debenture Holders on obtaining the consent of a certain majority of the Debenture In such a case, however, the arrangement has to be sanctioned by the Court, and the Court may, if it thinks the arrangement unfair, refuse its sanction.

Similarly as regards Preference Shareholders, provision may be made in the Company's Articles for the rights of the Preference Shares to be varied if sanction is given by the necessary majority (as defined in the Articles) at a separate meeting of those Shareholders.

Notwithstanding, however, any provision in the Articles, it is provided under the Companies Act that the holders of not less than 15 per cent. of the issued Shares of that class who do not consent to any proposed variation may apply to the Court to have the variation cancelled.

If, however, there is no such provision in the Company's Articles, then the Company may, under the Companies Act, by obtaining the approval of a majority in number amounting to three-fourths in value of the Preference Shareholders present personally or by proxy at the meeting, alter the Preference Shareholders' rights, such alteration being subject to the sanction of the Court.

The following example illustrates the practical effect of the foregoing machinery.

Let it be presumed that a Company whose business is worth £100,000 is asked to amalgamate that business with a larger business of a similar character owned by another Company. The last mentioned Company would clearly be the purchasing party, and the question would arise as to whether the purchaser should buy the business as such or whether it should purchase the securities of the Vendor Company from the individual holders. Let it be presumed that the Vendor Company is capitalized as follows:

£25,000 4% Debentures, £25,000 5% Preference Shares, £50,000 Ordinary Shares.

From the point of view of the amalgamation, it is most desirable that the business and not the securities

should be purchased. But if the business were purchased and liquidation of the Vendor Company were to proceed in the ordinary way, the 4 per cent. Debenture Holders would first be paid off, presumably at par, and the 5 per cent. Preference Shareholders at par. The market value of the 4 per cent. Debentures would at the present time clearly be much less than par, and the same remark would apply to the market value of the 5 per cent. Preference Shares. The Purchasing Company could, however, offer to the Vendor Company as part of the purchase consideration some of its own 4 per cent. Debentures and 5 per cent. Preference Shares (it is presumed that it has similar securities already issued and that the total issue of such securities could be enlarged). The Vendor Company could then offer a compromise to its Debenture Holders and Preference Shareholders, asking them to accept, par for par, 4 per cent. Debentures in the Purchasing Company for their own 4 per cent. Debentures, and 5 per cent. Preference Shares in the Purchasing Company for their own 5 per cent. Preference Shares. If the Debenture Holders and Preference Shareholders accept this compromise, this will, in due course, enable the Vendor Company to be liquidated, and the two businesses would then become one.

If, on the other hand, the Debenture Holders and Preference Shareholders of the Vendor Company declined to accept the compromise, then the only alternative open to the Purchasing Company would probably be to buy the Ordinary Shares of the Vendor Company from the individual Shareholders, and so

obtain control of that Company. The two businesses could then be worked in alliance with each other, although no actual merger of the Assets and Liabilities could take place, and the position would not, therefore, be quite as satisfactory as if a complete amalgamation had been effected.

The difference between the results of the two methods of treatment will be apparent from the following figures.

Let it be assumed that the 4 per cent. Debenture Capital of the Vendor Company is worth 80 per cent. of par, and that the 5 per cent. Preference Capital is also worth 80 per cent. of par.

The total value of the business has been assumed at ... £,100,000 and this value is apportionable between the Debenture Holders, the Preference Shareholders, and the Ordinary Shareholders. On the basis of the current market values of the Debentures and the Preference Shares, the Debenture Holders' interest $25,000 \times \frac{80}{100} = 20,000$ would represent the Preference Shareholders' interest $25,000 \times \frac{80}{100} = 20,000$ would represent 40,000 Therefore the Ordinary Shareholders' interest would represent the balance, namely £,60,000

The Purchasing Company has £100,000 (in cash or

kind) to offer for the business as such (or alternatively for the Shares and Debentures).

| If it acquired the securities from the individual holders it would offer to the Debenture Holders its own 4% Debentures of the nominal value of £25,000, but of the real value of £20,000 and it would offer to the Preference Shareholders its own 5% Preference Shares of the nominal value of £25,000, but of the real value of 20,000 | |
|---|----------|
| It would then be able to offer to the | 40,000 |
| Ordinary Shareholders security of the real value of | 60,000 |
| making in all | £100,000 |
| If, however, it acquired the business of the Vendor Company and the latter Company went into liquidation and paid off its Debenture Holders and Preference Shareholders in accordance with their respective rights, in such an eventuality it would have to give to its Debenture Holders security of | |
| the real value of | £25,000 |
| of the real value of | 25,000 |
| and it would only be able to give to its Or- | 50,000 |
| dinary Shareholders the balance, namely | 50,000 |
| | £100,000 |

It will, therefore, be seen that the Ordinary Share-holders of the Vendor Company would never assent to the second course—namely, the purchase of the business as such—unless there had been arranged in advance a compromise with the Debenture Holders and the Preference Shareholders.

It will be appreciated that where Holding Company schemes are in being and Debentures and Preference Shares in the Operating Companies are in existence, the Directors of the Holding Company (who directly or indirectly control the management of all the businesses concerned) must not take any step which is calculated to prejudice the interests of such Debenture Holders or Preference Shareholders, as otherwise the aggrieved party may bring an action against them. For example, the Directors of a Holding Company as exercising the voting control over the Operating Company are in a position to choose the Board of such Operating Company; in fact, the Board of each Operating Company may be identical in personnel. Decisions might conceivably be taken at Board Meetings of the various Operating Companies which would have the effect of diverting business from one Operating Company to another, even to such an extent as to close down the business of one Operating Company altogether. The effect of this on the position of the Debenture Holders or Preference Shareholders of the Company owning the business so closed down is obvious.

In some cases, difficulties such as those mentioned above are minimized by the Holding Company giving a guarantee in respect of the Debenture interest and Preference Dividends payable by its subsidiary Companies. In other instances the problem is solved by the Holding Company, subsequent to the acquisition of the Ordinary Shares, making an offer to the Debenture Holders and Preference Shareholders of the Subsidiary Companies to exchange their securities for securities of similar class in the Holding Company, which offer is accepted.

Another method of merger or unification of interests, which, however, is not so common as the complete amalgamation or the Holding Company arrangement, is what is known as the Pooling Agreement. businesses concerned enter into an arrangement whereunder their profits for a term of years are pooled -i.e. brought into a common fund-and are then divided up in certain proportions. For example, businesses 'A,' 'B,' and 'C' may find that during the past five years their profits have, on average, been in the ratio of 20, 50, 30. They may then enter into an agreement whereunder their combined profits for each of the next twenty years shall be divided between them in similar proportions—subject to various adjustments in regard, for example, to such matters as additional Capital introduced into each business during the twenty years. Having signed such an agreement, they can, during the twenty years, co-operate with each other freely in working the businesses and so avoid competition, as each business has an interest in the combined profits.

Pooling agreements may take many forms. The

example quoted above relates to a Pooling agreement in its widest form; it is, however, quite common to find Pooling agreements which do not cover the whole of the profits of the Companies concerned, but merely the profits of certain competing departments or sections of the businesses. Or, again, Pooling agreements may be based on sales and not on net profits; that is to say, the Companies whose sales exceed their fixed quotas under the agreement may have to pay into the Pool a certain sum per \pounds on the excess, the sums so paid in being drawn out by the Companies whose sales have fallen short of their quotas.

It is now convenient to mention how the various forms of merger affect the Balance Sheet of the Company which owns or controls the combined or allied businesses.

In the case of a complete amalgamation, the Assets of the various businesses would appear in the Balance Sheet in the ordinary way—i.e. grouped according to their nature, such as Land and Buildings, Plant and Machinery, Stock and Work in Progress, Book Debts, and so on; and the same remark would apply to the Liabilities. It would be very unusual for the Assets or the Liabilities of each business to be shown on the Balance Sheet separately.

In the case of the Holding Company, the holdings of that Company in the Subsidiary Companies would be shown in its Balance Sheet as Investments. Prior to the coming into operation of the Companies Act, 1929, there were no statutory requirements as to the manner in which the Balance Sheet of the Holding Company should disclose the interests in Subsidiary Companies. Now, however, certain regulations are laid down in this connection which must be complied with. (These will be found referred to in Appendix F.)

Briefly, the Holding Company must now state in its Balance Sheet the aggregate amount of its interest in Subsidiary Companies, distinguishing between Shares owned and amounts owing on loan or similar accounts. Further, the total amount owing by the Holding Company to its Subsidiary Companies must be shown separately from the other liabilities on the Balance Sheet of the former Company. There has also to be annexed to the Balance Sheet of the Holding Company a statement as to how the aggregate profits or losses of Subsidiary Companies have been dealt with so far as the Holding Company is concerned. Again, if the report of an Auditor to a Subsidiary Company on that Company's Balance Sheet is a qualified one, the statement annexed to the Holding Company's Balance Sheet is required to disclose the manner in which the report is qualified. It is, however, unnecessary for the actual names of the Subsidiary Companies to be disclosed.

In view of the large increase in the number of Holding Companies during recent years and of the desirability of Shareholders in such Companies being afforded reasonable information as to the interest in Subsidiary Companies, the above referred-to provisions are certainly called for. As a matter of fact, it has occasionally been the practice for Holding Companies to go a step further, and to issue for the information of

their Shareholders a Consolidated Balance Sheet in which the Assets and Liabilities of the various Subsidiary Companies are combined, under their various classes, with the Assets and Liabilities of the Holding Company. This procedure is most appropriate where the Holding Company owns the whole, or practically the whole, of the Share Capital of each Subsidiary Company. Where, however, a substantial portion of the Share Capital of one or more Subsidiary Companies is in outside hands the arguments in favour of a Consolidated Balance Sheet are not so strong. In such cases it will be appreciated that the Consolidated Balance Sheet can only include the proportionate part of the Assets and Liabilities of the Subsidiary Company, or, alternatively, it must show on the Liabilities side of the Company's Balance Sheet a figure to represent the book value of the outside or minority shareholders' interests which it does not own.

The legal position is, of course, that each Subsidiary Company is a separate and distinct entity; and the creditors of such a Company can only look to the Assets of that Company as security for the Company's indebtedness to them. Similarly in regard to profits and losses of Subsidiary Companies; these are not legally the profits or losses of the Holding Company, although the latter Company may hold every Share in the Subsidiary Company. From the strictly legal point of view a Holding Company cannot take to the credit of its Profit and Loss Account any profits of a Subsidiary Company except to the extent to which the Subsidiary Company declares a Dividend out of such profits.

Conversely, there is no legal obligation on the Holding Company to provide in its Accounts for any loss which a Subsidiary Company may sustain. In a sense, of course, the loss may be said to be sustained by the Holding Company, as such loss makes the investment in the Subsidiary Company correspondingly smaller in value. But a Company owning an investment which has depreciated in value is not considered liable legally to provide for such depreciation in arriving at profits available for Dividend, unless it is a Company which 'deals' in investments—i.e. purchases them with the primary object of disposing of them at a profit.

At the same time it is the common practice nowadays to look at such matters from what may be called the common-sense or economic, rather than the strictly legal, point of view in preparing the Balance Sheet of the Holding Company, and to see that due provision is made for any operating losses sustained by the Subsidiary Companies to the extent to which the Holding Company is prejudiced by reason of such losses.

A point which investors in Holding Companies should bear in mind in cases where there are prior issues (i.e. Debentures or Preference Shares) of the Subsidiary Companies in outside hands, is that, if the Holding Company itself has Debenture Capital, such Capital only ranks for interest out of funds available from each Subsidiary Company after the interest on the Debentures and the Dividends on the Preference Share Capital of that Subsidiary Company have been met, and it is similarly deferred as regards its capital rights. It may, therefore, happen that a Debenture in a

Holding Company is a Debenture in name rather than in essence.

Similarly the Dividends on Preference Share Capital of a Holding Company can only be paid out of Dividends coming to that Company from Subsidiary Companies after meeting the interest and Dividends on the Capital of the Subsidiary Company ranking in priority to the Capital owned by the Holding Company. In cases such as these a comparatively moderate decline in what may be called the working profits of the Subsidiary Companies may have a very serious effect upon the Dividends receivable by the Holding Company on the Ordinary Shares in such Subsidiary Companies owned by it.

As regards the third of the three chief forms of merger, namely the Pooling agreement, there is, in the great majority of cases, nothing in the Balance Sheets of the Companies concerned to indicate that any such arrangement is in force. The reason for this is, of course, that the Pooling agreement makes no difference to the ownership by each Company of its Assets, or the responsibility of each Company for its own Liabilities. At the end of each financial year certain of the Companies will be indebted to the 'Pool,' while others will be owed money by the 'Pool.' These balances would be included in the Balance Sheets of the respective Companies under heads such as 'Sundry Creditors' and 'Sundry Debtors' respectively.

A matter on which a few observations may be made is that of the disclosure or non-disclosure of mergers. Under a complete amalgamation the knowledge of the merger is unrestricted; it is patent to everyone, as all the businesses concerned are operated in the name of the one Company which owns them.

Under a Holding Company scheme, knowledge of the merging of interests will not be so widespread, as each of the Companies continues to operate under its own name; indeed, it is possible by certain special means to confine the knowledge to the Board of Directors of the Holding Company. Usually, however, the financial world is aware of the situation, though the man in the street may not be so.

Under a Pooling agreement a knowledge of the community of interests may quite easily be confined to the Boards of Directors of the Companies concerned, and the Shareholders may be quite unaware of it.

It is a question for the Directors of Companies concerned in a Combine to decide as to how far in regard to this matter of disclosure they should take Shareholders into their confidence. It must be remembered that it is, practically speaking, impossible to afford the information to Shareholders without giving it also to competitors. Public Companies engaged in competition with each other study critically each other's Balance Sheets, and read carefully the Chairman's speeches on the occasion of the Annual Meetings. Cases are by no means unknown where a competing Company has purchased a few Shares in the name of a nominee, and the latter has attended the Annual Meeting, and has asked questions designed to elicit information of value to a competitor.

In some cases Boards of Directors may feel justified in mentioning to their Shareholders that their Company is working in friendly co-operation with certain other Companies engaged in the same trade or industry, without entering into details which it might be contrary to the Company's best interests to disclose. In other cases the Directors may remain silent in what they conceive to be the true interests of the Shareholders themselves.

CHAPTER XI

CAPITAL REDUCTION SCHEMES -

Public Companies whose businesses or undertakings have suffered serious reverses may in time find themselves in a position where, owing to trading or operating losses, a considerable portion of their Floating Capital has disappeared, or where certain of their Assets stand in their Balance Sheets at figures very much in excess of their true worth. In such cases what is known as a 'Capital reduction' or 'Capital reorganization' scheme may be necessitated, with the object of placing the Company once more in a relatively satisfactory financial condition, and in order that its Balance Sheet may show more correctly the true position.

As its name implies, a Capital reduction scheme calls for a reduction in—or, in other words, a writing off of a portion of—the Issued Share Capital of a Company. This provides the means of extinguishing on the Assets side of the Balance Sheet the item representing the accumulated trading losses, and of writing down Assets which stand in the Balance Sheet at more than their true worth to the business.

As a general rule a Capital reduction scheme is not put forward until a Company's position, so far as earnings are concerned, has, relatively speaking, become stabilized. For example, if a Company, owing

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to circumstances believed to be exceptional, has sustained heavy losses, a Capital reorganization scheme would not ordinarily be prepared and put before the Shareholders for acceptance if losses were still being incurred. The scheme would be deferred until the Company was once more earning profits, and some idea could be formed as to what future profits might be likely to amount to. It will be appreciated that a Capital reorganization scheme involves, in effect, an appraisal of the Assets of the Company at their current worth to the business; and if the business were at the time still making losses, and the position was therefore full of uncertainty, the data on which a fair and proper valuation could be founded would be unreliable, or, at all events, inadequate.

It is also to be borne in mind that a Capital reduction scheme does not affect the business of the Company as such: the assets of the business are not altered in any way, although the nominal amount of the Issued Share Capital may be altered, and the book values of the assets may be altered. In other words, the alterations are not the result of real transactions, but merely of book-keeping entries.

It may be well to consider first a very simple example of Capital reconstruction, and then to pass to a review of cases where the circumstances are more complicated.

The simplest case is probably one where only one class of Share Capital exists; where there is no Debenture Capital; and where the Company has still sufficient liquid resources to enable it to carry on its business satisfactorily.

Let it be assumed that the Balance Sheet of the Company can be summarized as follows:

| Share Capital Issued: 300,000 Shares of £1 each, fully paid £300,000 Trade and other Creditors 10,000 | Amount paid for Goodwill £30,000 Land, Buildings, Plant, and Machinery Stock-in-Trade, Book Debts, and Cash Debtt balance on Profit and Loss Account 100,000 |
|---|---|
| £310,000 | £310,000 |

Let it be assumed that at the time when the Company was formed the business was earning profits at the rate of £30,000 per annum; that owing largely to exceptional and non-recurring circumstances losses have accumulated to the extent of £100,000 as shown in the Balance Sheet; that profits are now once more being earned, but that the industry is one which is not expected to be so profitable in future as in the past, and that it is not thought that this Company's profits for a number of years to come will exceed, say, £15,000 per annum.

The Directors, let it be assumed, review all the circumstances, and recommend the Shareholders to sanction a scheme for reducing the Share Capital from £300,000 to £150,000, by reducing each Share from £1 fully paid to 10s. fully paid.

The Directors point out that, owing to the reduced earning power of the Company's business, the Goodwill, which stands in the Balance Sheet at £30,000, cannot now be regarded as having any material value;

that the Share Capital is also unrepresented by Assets to the extent of the £100,000 debit balance on Profit and Loss Account; and that, after a careful review of the value of the Land, Buildings, Plant, etc., they have come to the conclusion that those Assets collectively, which appear in the Balance Sheet at a total of £140,000, are somewhat over-valued, and are not worth, to the business, more than £120,000.

If the scheme becomes effective the Balance Sheet will appear as follows:

| Issued Share Capital: 300,000 Shares of 10s. each fully paid £150,000 Trade and other Credi- | Land, Buildings, Plant, and Machinery £120,000 Stock-in-Trade, Book Debts, and Cash 40,000 |
|--|---|
| tors 10,000 | Debis, and Cash 40,000 |
| £160,000 | £160,000 |

If, as has been assumed, the Company's future net profits average £15,000 a year, these would be equivalent, if wholly distributed in Dividend, to a Dividend on the reduced Share Capital at the rate of 10 per cent. per annum, and, there being no accumulated debit balance to liquidate on Profit and Loss Account, the payment of Dividends could forthwith be resumed.

In order that the scheme may become effective it has first to be approved by the Shareholders by a special resolution (see Appendix B).

When the necessary sanction of the Shareholders has been obtained the Company must apply to the Court for an order confirming the reduction of Capital, and any Shareholder or Creditor has the right to appear at the hearing and put forward any objections he may have to the arrangement. When the order of the Court has been finally obtained, the Shareholders' resolution to reduce the Capital becomes effective.

A somewhat less simple case of Capital reduction would be that in which the Share Capital consisted in part of non-cumulative Preference Shares which ranked in priority to the Ordinary Shares both as to Dividend and Capital.

Let it be assumed that the position of such a Company is as shown by the following summary of its Balance Sheet:

| Share Capital Issued | Amount paid for Good- | |
|---------------------------|-------------------------|----------|
| and fully paid: | will | €30,000 |
| 100,000 7½% non- | Land, Buildings, Plant, | |
| cumulative Prefer- | and Machinery | 140,000 |
| ence Shares of £1 | Stock-in-Trade, Book | - |
| each £ 100,000 | Debts, and Machinery | 40,000 |
| 200,000 Ordinary | Debit balance on Profit | |
| Shares of £1 each 200,000 | and Loss Account | 100,000 |
| | | |
| 300,000 | | |
| Trade and other Credi- | | |
| tors 10,000 | | |
| £310,000 | | £310,000 |
| | | |

Let it be assumed as before:

- (a) That the value of the Goodwill has disappeared;
- (b) That the Land, Buildings, Plant and Machinery are not worth to the Company more than £120,000;
- (c) That therefore the Share Capital in total requires to

be reduced from £300,000 to £150,000 for the following purposes:

| To enable the Goodwill to be written off, | |
|---|---------|
| namely | £30,000 |
| To enable the Land, Buildings, Plant, and | |
| Machinery to be reduced by | 20,000 |
| To enable the debit balance on Profit and | |
| Loss Account to be written off, namely | 100,000 |

£150,000

and (d) that future profits are estimated to average about £15,000 per annum.

Let it be assumed that under the Company's Articles of Association each Share, Preference or Ordinary, has one vote, and that any alteration in the rights of any class of Shareholder must be sanctioned by a certain majority in value of the Shareholders of that particular class.

As will be seen, the position is an interesting one.

The Ordinary Shareholders possess the voting control of the Company, as collectively they have 200,000 votes as compared with the 100,000 votes exercisable by the Preference Shareholders. They are therefore in a position, on all matters of management and policy, to enforce their will. But they cannot vary in any way the rights of the Preference Shareholders without the latter's consent.

Clearly the £150,000 of Capital which has been lost is the Ordinary Shareholders' and not the Preference

Shareholders' Capital, as the latter have the priority in regard to Capital as well as in regard to Dividend. But so long as there is a debit balance on Profit and Loss Account the Directors of the Company (who are controlled by the Ordinary Shareholders through the latter's voting power) will probably not feel justified in declaring a Preference Dividend until subsequent profits have liquidated this balance; and even then they may, as a matter of policy, decide to apply the profits in writing down the item of 'Land, Buildings, Plant, and Machinery' which, as already explained, stands in the Balance Sheet at too high a figure. In brief, future profits for some considerable time to come would be applied towards replacing the Ordinary Shareholders' Capital which has been lost, and no portion would be distributed in Dividend to the noncumulative Preference Shareholders.

The case is clearly one for compromise; and it is suggested that the situation might fairly be met by the following arrangement:

- (a) The non-cumulative Dividend on the Preference Shares to be reduced in future from $7\frac{1}{2}$ per cent. to 6 per cent.;
- (b) The Ordinary Share Capital to be reduced from £200,000 to £50,000 by reducing each Share of £1 to 5s.
- (c) The voting power of the Ordinary Shareholders as a body not to be reduced; in other words, each Ordinary Share of 5s. would carry one vote, while each Preference Share of £1 would carry one vote.

Under the scheme the Balance Sheet would appear as follows:

| 100,000 6% non-cumulative Preference Shares of £1 each 200,000 Ordinary Shares | | Land, Buildings, and Machinery Stock-in-Trade, tors, and Cash | Deb- | £120,000 40,000 |
|--|----------|--|------|--------------------|
| of 5s. each | 50,000 | | | |
| Trade and other Credi- | 150,000 | | | |
| tors | 10,000 | | | |
| ; | £160,000 | | | £160,000 |

On the assumption that profits of £15,000 a year will in future be earned, the scheme, if approved, would enable Dividends to be resumed immediately on the Preference Share Capital at the reduced rate of 6 per cent. (i.e. £6,000 per annum), and a reasonable rate of Dividend to be paid on the reduced Ordinary Share Capital.

It will be noted under this scheme that the reduction in the nominal value of the Ordinary Share Capital, though apparently drastic, does not of itself represent any reduction in the real value of the Ordinary Shareholders' interests. The whole of the equity in the Company's business—that is to say, the value remaining after deducting the Preference Shareholders' interests, belongs to the Ordinary Shareholders, and it does not, therefore, matter whether this is represented on the Company's Balance Sheet by a figure of £50,000, as is the case under the scheme, or, for example, by £40,000 or by £60,000. If, for instance, the Directors in revaluing the Assets incidental to the reduction of the

Capital Scheme had left the item 'Land, Buildings, Plant, and Machinery' at £140,000 instead of reducing it to £120,000, the reduced Ordinary Share Capital, instead of being £50,000 in nominal amount, would have been £70,000. This would not, however, have benefited the Ordinary Shareholders in any way. The latter are entitled to the whole of the equity in the business, and the figure at which this right appears in the accounts is immaterial to them.

The above point is specially mentioned as it is frequently met with in Capital reorganization schemes. Where a class of Shareholder owns the whole of the equity in a business, then, broadly speaking, it does not matter whether that right is represented on the Company's Balance Sheet by £,10,000 or by £,100,000. It consequently follows that a reduction in the nominal Capital of such a class of Shareholder does not necessarily represent any real sacrifice. In the case, however, of a Preference Share the circumstances are quite different; a reduction in nominal value reduces the amount on which the fixed Dividend is payable, and it also reduces the fixed Capital sum returnable to the Shareholder in the event the Company's liquidation. It may be asked why, in these circumstances, should the whole of the sacrifice be borne by the Preference Shareholders by reduction of their fixed Dividend. The answer, as already will have been gathered, is that without a scheme profits would for a long time be used to recoup losses which have already fallen on the Ordinary Shareholders. Both classes of Shareholders are enabled

to participate at once in Dividends, and the reduction in the rates of Preference Dividend is a quid pro quo for this benefit.

It is now convenient to consider a somewhat more involved case of Capital reduction.

Let it be assumed that a Company's position is as shown by the following summary of its Balance Sheet:

| Share Capital—in Shares of £1 each (all of one | Amount paid for Good- will | £50,000 |
|--|-------------------------------|---------|
| | Land, Buildings, Plant, | , |
| 5% First Mortgage Deb- | etc | 280,000 |
| | Stock, Debtors, and | |
| Unsecured Creditors . 50,000 | Cash | 20,000 |
| - | Debit balance on Profit | |
| | and Loss Account | 100,000 |

£450,000

Let it be assumed that the Company's trading profits (i.e. before charging Debenture or any other interest) are estimated to be in future about £40,000 per annum, but that these can only be earned if (a) improvements to the Company's Plant, etc. are carried out at an estimated cost of £50,000, and (b) if further Capital is provided by reason of the estimated increased amounts of Stock and Book Debts which will exist in future to the maximum extent of £25,000, such increase being necessitated by the anticipated expansion of the Company's business. In other words, total additional Capital is required of £75,000. Without the provision of this additional Capital it is considered doubtful whether the business can earn any profits.

It is instructive to examine the position from the

point of view of each of the interested parties in turn.

As regards the Debenture Holders, the position has probably been reached, or will shortly be reached. where the Debenture Holders can claim that their interest or their Capital is in jeopardy and could have someone appointed as the Receiver to take control of the Assets pledged to them. The Receiver would presumably endeavour to sell the business as a going concern, or, in default of this, he would sell the Assets piecemeal, and he would endeavour, if possible, to realize a sufficient sum to enable the Debenture Holders to be repaid in full. It is, however, problematical whether he could do this. In the majority of cases fixed Assets used in a particular business are, owing to their location and nature, only worth sums approximating their cost when their use enables a reasonable profit to be made. If the Company cannot do so, then a purchaser who proposed to continue the business would only buy the Assets at a reduced value, and if no one could be found to do this, then the Fixed Assets would probably have to be sold at scrap value, or at a value which presupposed their use in future for purposes other than that of the class of business in which they had previously been utilized.

It is true that the Company's Fixed Assets have been shown in its Balance Sheet at £280,000 and the Floating Assets at £20,000—in total £300,000 as compared with £200,000, the amount of the Debenture debt. But without the provision of fresh Capital and the continuance of skilled management the Company cannot

earn profits, and, such being the case, it seems clear for the reasons explained that the real value of the Fixed Assets under existing conditions must be very considerably less than their book value. The Debenture Holders would therefore be open to consider any scheme the result of which should ultimately make the Debentures worth their face value, or a sum approximating it.

As regards the unsecured creditors, these must know that if the representative of the Debenture Holders took possession of the Fixed Assets and sold them piecemeal there would probably be no surplus left over for them; and they too would be willing to consider sympathetically any scheme which would enable them in due course to receive some consideration for what appeared to be a bad debt.

As regards the Shareholders, these must be aware that if the Debenture Holders foreclosed on the property and sold it nothing would be left for them. If, therefore, the Shareholders wished to retain any interest in the Company, they must be prepared to submit some scheme whereunder they, the Shareholders, make some real sacrifice or undertake some new responsibility. One strong card which the Shareholders have in their hands, let it be assumed, is the fact that the Directors and Managing Directors, whose services are important, if not essential, to the business, are large holders of Ordinary Shares, and if these men were content to sacrifice all interest in the Company and offer their services elsewhere the Company's business would suffer very materially.

The case is essentially one for compromise in the

interests of all parties. There are, of course, innumerable schemes which could be suggested. The following is put forward as one which has due regard to the various conflicting interests, and which is interesting as exhibiting the general nature of the compromises which are frequently found in practice:—

- (1) The Share Capital to be reduced from Shares of £1 each fully paid to Shares of 7s. 6d. each, 5s. paid, and the uncalled Capital, namely 2s. 6d. a Share, to be forthwith called up. This call would produce £25,000, and the issued Share Capital will then stand at £75,000.
- (2) Further Capital of £50,000 to be provided by the issue of 6% Prior Lien Debentures redeemable at a slight premium out of a 2% cumulative Sinking Fund.
- (3) The existing 5% Mortgage Debenture Holders to agree to the Prior Lien issue being placed in front of them, and also to agree to the following variation in their own rights:
 - (a) The rate of interest to be raised from 5% to 6%.
 - (b) The Debentures to be redeemed at a small premium out of a 2% cumulative Sinking Fund.
 - (c) The annual charge for Interest and Sinking Fund only to be met out of profits. In other words, if there were no profits available in any particular year the charge would lapse for that year. But

arrears of the charge will be cumulative—that is to say, they are to be met out of subsequent profits.

(4) The unsecured creditors to accept 7% Redeemable Preference Shares, such Shares being redeemable out of a Sinking Fund of 7% provided out of profits before any profits are available for the Ordinary Shareholders.

Note—The machinery by which this arrangement would be carried through would entail the liquidation of the existing Company and the purchase of its business by a new Company of a similar name which would issue its securities as consideration therefor. It would not, for example, be legal for the existing Company merely to reduce its Capital. The practical effect of the arrangement is, however, as described in the foregoing paragraphs.

When the reconstruction on the foregoing lines had been duly carried through and the £50,000 spent on improvements to Plant, etc., the Company's position would be as shown by the following summary of the Balance Sheet:

| Share Capital Issued: | | Land, Buildings, | | |
|------------------------|---------|------------------|---------|----------|
| 200,000 Ordinary | | etc., per last I | Balance | |
| Shares of 7s. 6d. each | | Sheet £2 | 80,000 | |
| fully paid | £75,000 | Add: | | |
| 50,000 7% Redeem- | | Subsequent | | |
| able Preference Shares | 50,000 | additions | 50,000 | |
| | | - | | £330,000 |
| | 125,000 | Stock-in-Trade, | Deb- | |
| 6% Prior Lien Deben- | | tors, and Cash | | 45,000 |
| tures | 50,000 | | | |
| 6% Income Debentures | 200,000 | | | |

| | • |
|--|---------|
| If trading profits are earned as anticipated at a rate per annum of these would be absorbed as follows: | £40,000 |
| Prior Lien Debenture Service (6% Interest and 2% Sinking Fund on | • |
| £50,000) £4,000 | |
| Income Debenture Service (6% | |
| Interest and 2% Sinking Fund on | |
| \pounds 200,000) 16,000 | |
| 7% Dividend on Redeemable | |
| Preference Share Capital of | |
| £50,000 3,500 | |
| 7% Sinking Fund on Redeem- | |
| able Preference Share Capital of | |
| £50,000 3,500 | |
| and the second s | |
| | 27,000 |
| Leaving available for Dividend on the Or- dinary Share Capital and for Reserves the | |

T dinary Share Capital and for Reserves the sum of £,13,000

which represents between 15% and 20% on the Ordinary Share Capital.

It will, therefore, be seen that if profits are maintained at or about £40,000 a year it will have been well worth the while of the Ordinary Shareholders to have contributed the £25,000 additional Capital ranking behind all other interests, in order to preserve their equity in the business; and, even if profits average in future no more than £30,000 a year, all the other interested parties will in due course be paid out in full, and will, in the meantime, have been receiving a reasonable

rate of interest or dividend on their money. Further, when all these prior security holders have been paid out, the whole of the trading profits of the Company will be available for Dividend on the Ordinary Share Capital, and the value of the latter will have been considerably enhanced by the retention in the business of profits which have been set aside to repay, and therefore eliminate, the Debentures and Preference Share Capital.

An important point to note in the scheme is that, if the Company's business again enters upon hard times and earns no profits, only £4,000 a year has to be disbursed in respect of Interest and Sinking Fund, namely, in respect of the Prior Lien Debentures. No payments are made to other preferential security holders—i.e. Income Debenture Holders or Preference Shareholders—unless profits are earned out of which such disbursements can come. This is a feature which should ordinarily obtain in any well-devised Capital Reconstruction scheme.

Another necessary feature is that provision should be made for fully adequate cash resources, so that the Company may be able to meet any payments which are at all likely in this connection. In the case under consideration the Company has provided itself with the maximum amount of floating Capital which it thinks it is likely to need; but it is clear that it could not survive any very long period of depression in which losses were accumulating. This seems unavoidable under the circumstances; and if such an unfortunate situation should arise it would be a matter for the

Shareholders to consider whether they would contribute any more Capital in order to preserve their interest in the Company. A Company making losses finds it difficult to raise money; and this is especially the case where, as in this instance, heavy Debenture debts are in existence. The Directors of the Company would therefore be wise, for some years to come, to retain in the business a substantial part of the annual profits remaining after satisfying the demands of the Prior Security holders; in other words, they should strictly limit the Dividends on the Ordinary Share Capital. As and when, in course of time, the Prior Securities were paid off out of the Sinking Funds provided for such purpose, the Company's financial position would be very much stronger.

An isolated point in connection with schemes for reduction of Capital which might be mentioned concerns the question of depreciation of Fixed Assets, such as Buildings, Plant, and Equipment. Obviously, the higher the figure at which these Assets stand in a Company's Balance Sheet the larger the sum which the Company must provide annually by a charge in respect of depreciation in arriving at its profits, as the charge for depreciation is calculated on the basis that it will reduce the book value of the Asset to scrap value by the time that the economic value of the Asset to the business has disappeared. The effect, therefore, of a drastic reduction in the book values of these Assets under a Reconstruction Scheme is that a correspondingly smaller sum will require, in future, to be provided

annually in respect of depreciation, and consequently the net profits shown by the Company's annual Accounts will be larger than would otherwise be the case.

Little has been said in this chapter about the machinery by which schemes for reduction of Capital are carried through. These, it is submitted, are matters for the various classes of expert rather than for the ordinary business man who owns investments. The latter is justified in assuming that whatever legal and other steps are necessary to carry a scheme into operation will be taken, and he is more concerned with reviewing the scheme as such and making up his mind whether it deals fairly with the particular class of security in which he is interested.

If the Investor considers that a scheme which has been put forward is prejudicial to the particular security of which he is a holder, he may think it well to ascertain—by application to the Company, or by consulting his Solicitor—whether he has the right to appear when the scheme comes before the Court for approval, and oppose it.

Very many Capital Reduction Schemes have been carried through by public Companies during recent years; they are the aftermath of the period of depression which followed the war-time and post-war boom. Some are very ingenious, others very complicated; while others fall under both descriptions. It is not possible in a book of this size, dealing with such a variety of matters in connection with public Companies, to do more than has been done in this chapter—namely, to

give a general review of the main considerations which are involved in such schemes, and to indicate by examples the manner in which they are usually dealt with.

There occur, in practice, classes of Capital Reduction Schemes of an entirely different character from those already referred to in this chapter.

For example, a Company may find that its Capital is altogether surplus to its actual or anticipated requirements, and it may consequently decide to return such surplus Capital to its Shareholders. The distribution may be made in cash, or, alternatively, it may be made in kind; for instance, a Company may distribute among its Shareholders certain investments (i.e. securities) which it owns. Such Capital Reduction Schemes are different from those previously referred to in that they involve real transactions.

Another class of Capital Reduction Scheme is one which does not effect any reduction in the amount of the issued and paid-up Share Capital of a Company, but which merely reduces or eliminates the amount of uncalled Capital. For example, a Company's issued Share Capital may be composed as follows:

100,000 Shares of £1 each, on which 15s. a Share has been called and paid up.

The Company may take the necessary steps to cancel the uncalled Capital, and when this has been done the Capital would be composed of

100,000 Shares of 15s. each, fully paid.

CHAPTER XII

LIQUIDATIONS AND RECEIVERSHIPS

Having regard to the objects with which this book has been written, it is considered unnecessary to do more than indicate in very broad outline the meaning and nature of Liquidations and Receiverships.

A Liquidation as regards a Limited Liability Company is the process by which the Company is put out of existence. The liquidation involves the realization of the Assets, the discharge of Liabilities so far as the proceeds from the realization of the Assets will allow, and the distribution of the surplus, if any, among the Shareholders according to their respective rights.

The fact that a Company goes into liquidation does not necessarily mean that the Company is insolvent. The Shareholders of a Company, by the proper resolution, have it in their power at any time to order the liquidation of the Company; they may, for example, desire that the Company's business shall be sold and the proceeds, after meeting the Liabilities, distributed among them, the Shareholders. Or liquidation may be a step towards reconstruction or amalgamation, when, after providing for Liabilities, the Shareholders receive a new share interest in another Company.

In some cases liquidations are ordered by the High Court, or other Courts of competent jurisdiction; in other cases they may be carried out subject to certain supervision by the Court; and, in other cases again, they may be carried through 'voluntarily,' without any Court supervision.

A winding up by the Court is initiated by a petition presented either by the Company itself, by a Shareholder, or by a Creditor asking that the winding up shall take place for reasons set out in the petition, as, for example, that the Company is unable to meet its liabilities in full.

A voluntary winding up is initiated by a resolution of the Shareholders at a General Meeting.

Under all circumstances a person known as a Liquidator is in due course appointed, and the Liquidator is only entitled to carry on the business of the Company if such carrying on is necessary for the purpose of realizing the Assets to the best advantage. In certain cases what is known as a Committee of Inspection—that is to say, a Committee composed either wholly of persons who are Creditors or partly of Creditors and partly of Shareholders of the Company—is appointed, whose general function is to watch the progress of the liquidation, and with whom the Liquidator confers on certain specific occasions and on matters of general importance.

The Companies Act contains a large number of provisions defining the procedure in liquidation, and the duties of Liquidators; into these technical matters it is not appropriate to enter here.

In a Receivership a person known as a Receiver is appointed in the interests of a Creditor or number of Creditors, generally Debenture Holders, to take

possession and control of the Assets of a Company which have been charged in favour of such Creditors as security for the payment of their Debentures or other debts. If the situation is not otherwise dealt with to the Receiver's satisfaction, the Receiver realizes the Assets and the proceeds are applied so far as they permit to the discharge of the Debentures or secured debt.

A Receiver may be appointed

- (a) by the person in whose favour the charge is created acting under a power in that behalf contained in the document of charge, or
- (b) by the Court in an Action instituted for the purpose of enforcing the security created thereunder.

A Debenture does not necessarily constitute a charge upon the property of a Company, although unsecured Debentures are uncommon, and a Receivership could, of course, never arise in such cases.

Debentures may be secured either by a fixed charge or mortgage upon specific Assets or by a floating charge over Assets generally, or partly in the one way and partly in the other. Where the Assets are only subject to a floating charge the Company can deal with them in the ordinary course of carrying on its business, until circumstances arise when the charge becomes enforcible, when, upon the appropriate steps being taken, the charge crystallizes and becomes a fixed charge.

The charge created by Debentures usually becomes enforcible upon failure by the Company to fulfil the

terms imposed upon it under the Debentures, notably those relating to payment of interest and repayment of capital. A Receiver is, however, sometimes appointed when it is proved that the security is in jeopardy, although there may have been no actual default on the part of the Company—e.g. if unsecured Creditors are seizing the Assets, or threatening to do so.

Subject to the payment of the preferential debts specified in the Companies Act, the secured Debenture Holders rank in front of the ordinary Creditors of the Company in respect of the proceeds of realization of the Assets charged by the Debentures. Any surplus of such proceeds, after payment of the full amounts due under the Debentures, is handed over to the Company, or its Liquidator.

So long as:

- (a) The terms of the Debentures are being adhered to—e.g. as to the payment of Interest and the repayment of Capital, and
- (b) the security for the Debentures is not in jeopardy, and
- (c) no circumstances which, under any of the terms of the Debentures, give the right to the Debenture Holders to take special action have arisen, and
- (d) the Company has not gone into liquidation,

the Debenture Holders cannot, by means of the appointment of a Receiver, or by any other means, take steps to obtain repayment. They have made their bargain with the Company at the outset; the Company

is adhering to the terms of the bargain; and the Debenture Holders must do likewise.

The Companies Act contains certain provisions relating to the duties of Receivers. It would be out of place to attempt to describe these in this book.

APPENDIX A

EXAMPLES ILLUSTRATING VARIOUS RIGHTS WHICH MAY ATTACH TO PARTICIPATING PREFERENCE SHARES

PRELIMINARY Note.—It is not suggested that there are to be found Participating Preference Shares which would fall under each of the categories described in this Appendix. The object of the Appendix is to illustrate different types of rights; and to indicate the different positions in which the Directors of a Company may find themselves incidental to the question of the declaration of a dividend on Participating Preference Shares.

Particulars are given in this Appendix of the manner in which the balance shown on a Company's Profit and Loss Account would be dealt with in various circumstances.

In the first place, four different alternatives are assumed as regards the rights of the Participating Preference Shares in respect of dividend. Then, under each of these four alternatives, the case is firstly considered where there is no objection to the whole of the balance on Profit and Loss Account being distributed in dividend, and the case is secondly considered where the Directors regard it necessary to retain in the business approximately one-half of the amount standing at the credit of Profit and Loss Account, as it is assumed that the business would otherwise have insufficient floating capital.

In all cases, for the sake of simplicity, Income Tax is ignored.

Let it be assumed that the Balance Sheet of a Public Company at 31st December, 1928, can be summarized as follows:

| SHARE CAPITAL AUTHOR- 1ZED AND ISSUED: 100,000 7% Participating Preference Shares of £1 each £100,000 (Note—The last dividend paid in respect of these Shares covered the period up to 31st December, 1926) 200,000 Ordinary Shares of £1 each 200,000 | |
|--|-----------|
| TRADE LIABILITIES 300,000 | |
| PROFIT AND LOSS ACCOUNT: Profits for year to 31st December, 1928 £50,000 Less: Debit balance brought forward at 31st December, 1927 8,000 | |
| £350,000 | £,350,000 |
| ₹,3,50,000 | 2,330,000 |

CASE I

ASSUMED RIGHTS OF PARTICIPATING PREFERENCE SHARES AS TO DIVIDEND

The Preference Shares are entitled to a Cumulative dividend at the rate of 7% and to participate *pro rata* with

the Ordinary Shares in any surplus profits available for dividend, but with a limit of 8%, making 15% in all.

Treatment of Credit Balance on Profit and Loss Account

(Assuming that the Directors see no objection to its being distributed practically entirely in Dividend)

| In this case, as the dividend is cumulative, the profits have first to be utilized to pay the fixed Preference dividend in respect of 1927, viz. 7 % on £100,000 | £7,000 7,000 |
|--|-----------------|
| | £14,000 |
| The total available profits as shown by the Balance Sheet are | |
| there remain profits of | |

These profits can be divided pro rata between the Preference Shares and the Ordinary Shares, that is to say 1/3rd of them can be paid to the Preference Shareholders and 2/3rds to the Ordinary Shareholders, subject, however, to the limitation that the Preference Shareholders cannot receive more than 15% in all, in respect of any one year.

Profits of £28,000 would enable further dividends to be paid on the total Share Capital at the

rate of 9%, absorbing £27,000, and leaving to be carried forward £1,000. But the Preference Shareholders are not entitled to any further dividend in excess of 8%; this absorbs ... £

.. £8,000 iz. he .. 20,000

This will enable the Ordinary Shares (viz. 200,000 of £1 each) to receive a dividend at the rate of 10%, absorbing

making a total of £28,000

In all, therefore, the Preference Shareholders would receive in respect of 1927, 7%, and in respect of 1928, 15% (their maximum dividend), and the Ordinary Shareholders would receive 10%. No profits would remain to be carried forward to the next year.

TREATMENT OF CREDIT BALANCE ON PROFIT AND LOSS ACCOUNT

(Assuming that the Directors consider that only approximately one-half of it is available for Dividend, it being necessary to retain the other half in the business as otherwise, there would be insufficient Floating Capital)

| The credit balance on Profit and | |
|---|---------|
| Loss Account | £42,000 |
| would first be required to meet the | |
| cumulative dividend on the Preference | |
| Shares in respect of 1927, absorbing £7,000 | |
| and the similar dividend in respect of | |
| 1928, absorbing 7,000 | |

These two dividends total 14,000

leaving a balance of .. £28,000

| Brought forward The Board having decided that only approximately one-half of the credit balance of \pounds 42,000 on Profit and Loss Account can be made available for dividend, there would be placed to | £28,000 | | | |
|---|---------|--|--|--|
| General Reserve Account the sum of, say | 22,000 | | | |
| leaving available for further dividends the balance of | £6,000 | | | |
| This being divided <i>pro rata</i> among the Preference and Ordinary Shares would enable an additional dividend on the Preference Shares to | | | | |
| be paid at the rate of 2 %, absorbing and on the Ordinary Shares at the rate of | £2,000 | | | |
| 2%, absorbing | 4,000 | | | |

£6,000

In all, therefore, the Preference Shareholders would receive, in respect of 1927, 7%, and in respect of 1928, 9%; and the Ordinary Shareholders would receive 2%, while there would be transferred to General Reserve Account the sum of $f_{122,000}$.

CASE II

ASSUMED RIGHTS OF PARTICIPATING PREFERENCE SHARES AS TO DIVIDEND

The Preference Shares are entitled to a cumulative dividend at the rate of 7%, and to one-half of the surplus profits available for dividend, but with a limit of 8%, making 15% in all.

TREATMENT OF CREDIT BALANCE ON PROFIT AND LOSS ACCOUNT

(Assuming that the Directors see no objection to it being distributed practically entirely in Dividend)

| practically entirely in Dividend) | |
|--|---------|
| In this case, as the dividend is cumulative, the profits have first to be utilized to pay the fixed Preference dividend in respect of 1927, namely | |
| 7% on £100,000 | £7,000 |
| dividend for 1928, which will absorb | . 7,000 |
| making a total of | £14,000 |
| On deducting from the total available | |
| profits, as shown by the Balance Sheet, namely | £42,000 |
| the fixed dividends referred to above, totalling | 14,000 |
| there remain profits of | |
| receive would be | 8,000 |
| which would leave available for the Ordinary | |
| Shareholders | £20,000 |

In all, therefore, the Preference Shareholders would receive in respect of 1927, 7%, and in respect of 1928 their maximum dividend of 15%, and the Ordinary Shareholders would receive (on their Capital of £200,000) a

dividend at the rate of 10%, and there would be no amount left at the credit of Profit and Loss Account to be carried forward to the next year.

TREATMENT OF CREDIT BALANCE ON PROFIT AND LOSS ACCOUNT

(Assuming that the Directors consider that only approximately one-half of it is available for Dividend, it being necessary to retain the other half in the business, as otherwise there would be insufficient Floating Capital)

| The credit balance on Profit and Loss Account, namely would first be required to meet the cumulative | £42,000 | | | |
|--|---------|--|--|--|
| dividend on the Preference Shares in respect of | | | | |
| 1927, absorbing £7,000 | • • | | | |
| and the similar dividend in respect of | | | | |
| 1928, absorbing 7,000 | | | | |
| · entransación de la constitución de la constitució | 14,000 | | | |
| leaving a balance of | £28,000 | | | |
| Bearing in mind the necessity as to the re- | | | | |
| tention of sufficient floating capital in the busi- | | | | |
| ness, let it be assumed that the Directors decide | | | | |
| to transfer to General Reserve Account at least | | | | |
| one-half of the total credit balance on Profit and | | | | |
| Loss Account at 31st December, 1928, of £42,000, | | | | |
| say | 22,000 | | | |
| , | | | | |
| This would leave a balance available for | | | | |
| dividends of | £6,000 | | | |

| Of this, one-half would go to the Preference Shareholders, namely | £3,000 3,000 |
|---|-----------------|
| senting a dividend of 1½% on the Ordinary Share Capital of £200,000 | £6,000 |

In all, therefore, the Preference Shareholders would receive in respect of 1927 their cumulative dividend of 7%, and in respect of 1928 they would receive 10%. The Ordinary Shareholders would receive 1½%, and there would be carried to General Reserve Account a sum of £22,000.

CASE III

ASSUMED RIGHTS OF PARTICIPATING PREFERENCE SHARES AS TO DIVIDEND

The Preference Shares are entitled to a non-cumulative dividend at the rate of 7%, and to one-half of the surplus profits available for dividend, but with a limit of 8%, making 15% in all.

TREATMENT OF CREDIT BALANCE ON PROFIT AND LOSS ACCOUNT

(Assuming that the Directors see no objection to its being distributed practically entirely in Dividend)

| The a | vailabie | profits | shown | by the | Balan | ce | |
|-----------|----------|---------|-------|--------|-------|----|---------|
| Sheet are | | | | | | | £42,000 |

| Brought forward The Participating Preference Shares, not being cumulative, are not entitled to any divi- dend in respect of 1927. In respect of 1928, however, they are first entitled to their fixed | £42,000 |
|--|---------|
| dividend of 7%, absorbing | 7,000 |
| leaving a balance of available profits of If one-half of these could be allocated to the Preference Shareholders, the latter would receive £17,500, equivalent to a dividend of $17\frac{1}{2}\%$. They are, however, only entitled to a further dividend | £35,000 |
| of 8%, which absorbs | 8,000 |
| leaving available for the Ordinary Shareholders a balance of | £27,000 |

This balance would be sufficient to pay, on the Ordinary Share Capital of £200,000, a dividend of $13\frac{1}{2}\%$.

The position, therefore, is that, in respect of 1927 the Preference Shareholders receive nothing; in respect of 1928 they receive their maximum dividend of 15%, while the Ordinary Shareholders in respect of 1928 receive 13½%. No balance would remain on Profit and Loss Account to be carried forward to the subsequent year.

TREATMENT OF CREDIT BALANCE ON PROFIT AND LOSS ACCOUNT

(Assuming that the Directors consider that only approximately one-half of it is available for Dividend, it being necessary to retain the other half in the Business as otherwise there would be insufficient Floating Capital)

Brought forward £42,000

The Preference Shares, being non-cumulative, are not entitled to any dividend for 1927. They are, however, entitled in respect of 1928 to their fixed cumulative dividend of 7%, absorbing

7,000

leaving a balance of profits of ... It is, however, to be assumed that the Directors think it necessary to retain about one-half of the credit balance on Profit and Loss Account at 31st December, 1928, in the business, in order to maintain adequate floating capital. Let it therefore be assumed that they make a transfer to the General Reserve Account of ...

This would leave an available balance of

One-half of this would belong to the Preference Shareholders (giving them a dividend of

The remaining one-half would belong to the Ordinary Shareholders (giving them a dividend

In all, therefore, the Preference Shareholders would receive in respect of 1927, nil; in respect of 1928, 14%, while the Ordinary Shareholders would receive, in respect of 1928, $3\frac{1}{2}\%$; and there would be carried to General Reserve Account a sum of £21,000.

CASE IV

ASSUMED RIGHTS OF PARTICIPATING PREFERENCE SHARES AS TO DIVIDEND

The Preference Shares are entitled to a non-cumulative dividend at the rate of 7%, and to one-half of the surplus profits then remaining, but with a limit of 8%, making 15% in all.

TREATMENT OF CREDIT BALANCE ON PROFIT AND LOSS
ACCOUNT

(Assuming that the Directors see no objection to its being distributed practically entirely in Dividend)

| The credit balance on Profit and Loss Ac- | |
|--|---------|
| count is | £42,000 |
| The Preference Shares, being non-cumula- | |
| tive, are not entitled to any dividend in respect of | |
| 1927. They are, however, entitled to the fixed | |
| cumulative dividend of 7% in respect of 1928, | |
| absorbing | 7,000 |
| This leaves a balance of | £35,000 |
| If one-half of this balance could be avail- | |
| able for the Preference Shareholders, they would | |
| receive £17,500, but they are only entitled to | |
| receive a further dividend at the rate of 8%, | |
| absorbing | 8,000 |
| leaving a balance of profits of | £27,000 |
| which would enable a dividend to be paid on | |

which would enable a dividend to be paid on the Ordinary Share Capital of £200,000 at the rate of $13\frac{1}{2}\%$.

In all, therefore, the Preference Shareholders would receive nothing in respect of 1927, but they would receive their maximum dividend of 15% in respect of 1928, and the Ordinary Shareholders would receive, in respect of 1928, 13½%.

TREATMENT OF CREDIT BALANCE ON PROFIT AND LOSS ACCOUNT

(Assuming that the Directors consider that only approximately onehalf of it is available for Dividend, it being necessary to retain the other half in the business as otherwise, there would be insufficient Floating Capital)

The credit balance on Profit and Loss Account is £42,000

The Preference Shares, being non-cumulative, are not entitled to any dividend in respect of 1927. In respect of 1928, they are first entitled to their fixed cumulative dividend of 7%, absorbing 7,000

leaving a balance of profits of .. £35,000

The Directors, however, consider it necessary to retain approximately one-half of the credit balance on Profit and Loss Account at 31st December, 1928—namely £21,000, in the business—in order to maintain the requisite floating capital. Inasmuch, however, as the Preference Shareholders are entitled to their share of the actual surplus profits (irrespective of whether the Directors consider such surplus

Brought forward £35,000

profits to be wholly available for dividend or not), they must not be prejudiced by the Directors' desire to retain the profits in the business, so long as the Directors are in a position to retain in the business, out of the profits which would otherwise go to the Ordinary Shareholders in dividend, sufficient profits for the needs of the undertaking.

If the Preference Shareholders were entitled to one-half of the before-mentioned sum of £35,000, this would give them £17,500, or a dividend at the rate of $17\frac{1}{2}\%$. Their maximum further participation is, however, limited to 8%. This absorbs, on the Preference Share Capital of £100,000

8,000

leaving a balance of profits of and it is out of this latter balance that the Directors are entitled to make appropriations to General Reserve.

£27,000

Assuming they appropriate to General Reserve the sum of 21 (namely one half of £42,000)

21,000

this would leave a balance of

£6,000

which would enable a dividend to be paid on the Ordinary Share Capital of £200,000 at the rate of 3%.

In all, therefore, the Preference Shareholders would receive in respect of 1927, nil; in respect of 1928, 15%;

while the Ordinary Shareholders would receive, in respect of 1928, 3%, and there would have been carried to General Reserve Account the sum of £21,000.

Note—The expression 'available for dividend' is used a number of times in this Appendix. In this connection the reader's attention is drawn to the remarks on this particular point in Chapter IV.

APPENDIX B

NOTES REGARDING SHAREHOLDERS' VOTES

Brief reference was made in Chapter IV. to the question of the voting rights exercisable by the holders of shares in Public Limited Companies. In this Appendix the matter is explained in somewhat greater detail.

The Companies Act, 1929, does not define what classes of Shareholders are entitled to votes; this question is left to be settled by each Company by means of suitable provisions being inserted in that Company's Articles of Association (see Chapter III. in regard to Articles of Association). The Act does, however, state what classes of resolutions can be passed by such Shareholders as are entitled to vote, and it also sets out certain special matters which can only be dealt with by a certain class of resolution.

The classes of resolution are three in number:

- (1) An ordinary resolution.
- (2) An extraordinary resolution.
- (3) A special resolution.

An Ordinary Resolution is a resolution passed by a simple majority of votes cast by the Shareholders present at a meeting and voting. Matters for which an ordinary resolution of Shareholders would be required would include the approval, at the Annual General Meeting of the Company, of the annual Balance Sheet and Report as submitted by the Directors; the payment of dividends; the election of Directors; and the election and remuneration of the Company's Auditors.

In the usual way an ordinary resolution is passed on a show of hands—that is to say, each Shareholder present would, on a show of hands, be counted as having one vote. The Companies Act provides that, unless the contrary is stated in a Company's Articles of Association, each Shareholder has one vote, but the Company's Articles usually provide that on a poll each share shall confer one vote. Thus, in such a case, if a resolution is put to a meeting and voted on by a show of hands, the necessary number of Shareholders dissatisfied with the result could demand a 'poll,' and in the case of a poll each Share would carry one vote-in other words, a Shareholder owning 100 Shares entitled to votes would have 100 times the voting power of another Shareholder who only holds one of such Shares. In the case of a poll, it is usual to provide that the votes counted need not merely be confined to Shareholders present at the meeting; but that a Shareholder who wishes to vote, but cannot conveniently be present at the meeting, may give a document, named a proxy, to some other person, which document entitles that person to exercise the votes to which the Shareholder is entitled by reason of his holding.

An Extraordinary Resolution is a resolution which has been passed by a majority of not less than three-fourths of the votes exercised, the meeting to be one of which due notice of the intention to propose the extraordinary resolution has been given. A Company may, for example, place itself in voluntary liquidation by passing an extraordinary resolution of the Shareholders to the effect that it cannot by reason of its Liabilities, continue its business, and that it is advisable to wind up.

A resolution is a Special Resolution when it has been passed by the majority required for the passing of an

extraordinary resolution and at a General Meeting of which not less than twenty-one days' notice, specifying the intention to propose the resolution as a special resolution, has been given.

Among the matters for which special resolutions are required as provided in the Companies Act, are any alterations in the Company's Articles of Association; also any reduction of the Share Capital; also any alteration in the objects clause in the Company's Memorandum of Association.

Where Shares in a Company consist of different classes, the question arises as to the voting rights to be attached to each class. As already mentioned in Chapter IV., it is not unusual in the case of Preference Shares carrying a fixed dividend to provide that, so long as the fixed dividend is promptly paid, they are not entitled to any votes. In certain exceptional circumstances, however, it would, or might, be provided in the Company's Articles that the Preference Shareholders could exercise votes, such as, for example, in regard to a proposal to sell the Company's business, or to put the Company into liquidation, or to alter the Articles of Association.

Table 'A' (which, as explained in Chapter III., is attached to the Companies Act as a model set of Articles, and which would be enforceable except to the extent that the contrary was provided in a Company's own Articles of Association) stipulates that the rights of any class of Shareholder can only be varied with the consent of that particular class, and such consent must either be given in writing by the holders of three-fourths of the whole issue of Shares or by a three-fourths majority of the votes exercised at a meeting of such class specially called for the purpose.

It will, therefore, be appreciated that no matter how great the voting-power of the Ordinary Share Capital of a Company may be, as compared with the voting power of the Preference Share Capital, the Ordinary Shareholders have no power under the provisions of Table 'A' to alter the rights of the Preference Shareholders; and, further, the Preference Shareholders themselves cannot alter their rights by a bare majority of the votes which they are entitled to exercise; a three-fourths majority is necessary. It should, however, be clearly understood that Table 'A' is not obligatory; it is only permissible. A Company which does not adopt Table 'A' can, at its inception, place whatever limitations it chooses upon the powers of its Preference Shareholders; but, once having created the Preference Shares and registered its Articles of Association, it cannot alter the rights of the Preference Shareholders without the consent of whatever majority of such Shareholders is prescribed in the Articles in such a contingency.

APPENDIX C

EXAMPLE ILLUSTRATING THE EVILS ARISING FROM THE UNSOUND CAPITALIZATION OF A PUBLIC COMPANY

Let it be assumed that an Engineering business, which has for many years been in private ownership, is acquired by a Public Limited Liability Company in the year 1920.

The profits earned have been at the rate of £40,000 per annum, and the public Company paid as purchase price for the business £400,000 and issued its Capital in the following form:

6% Mortgage Debentures (redeemable at par, 31st December, 1930) £100,000
8% Cumulative Preference Shares of £1 each .. 200,000
Ordinary Shares of £1 each .. 100,000

£400,000

Let it be assumed that the Balance Sheet of the new public Company at its inception can be summarized as follows:

Share and Debenture
Capital as above ..£400,000

Capital as above ..£400,000

Stock-in-trade, Work in Progress, Book Debts, and Cash £245,000

Less: Trade
Creditors 20,000

225,000

Goodwill 75,000

| It will be observed that if the profits continue at the rate |
|--|
| of £40,000 per annum, these profits would be sufficient to |
| pay |
| the interest on the Debentures (namely 6% on |

| 1 / | |
|--|--------|
| the interest on the Debentures (namely 6% on | |
| £100,000) | £6,000 |
| the Dividend on the Preference Shares (namely | |
| 8% on £200,000) | 16,000 |
| a Dividend at the rate of 12½% on the Ordinary | |
| Share Capital of £100,000, namely | 12,500 |
| | |
| and to place to Consent December Associate the | |
| and to place to General Reserve Account the | |
| balance of | 5,500 |

Total profits £,40,000

5,500

It is suggested, however, that the above capitalization is inherently unsound.

The purchase price as a whole can be defended as not excessive, considering the earning capacity of the business, although it results in a substantial figure having to be attributed to Goodwill, namely £,75,000, because the value of the total tangible assets of the business, less the trade liabilities, is only f,325,000 which falls short of the total purchase price by 75,000

Total purchase price £400,000

Where the capitalization is unsound is in the manner in which the Capital is divided up. In the first place, it is to be noted that the nominal value of the Preference Share Capital is twice the nominal value of the Ordinary Capital, and this in spite of the fact that there ranks in front of the Preference Share Capital, Debenture Capital. In the case

of Public Limited Companies owning industrial undertakings, one would expect to find that the Ordinary Share Capital is at least as large as, and probably larger than, the Preference Capital. The larger the Preference Capital in ratio to the Ordinary Capital the less 'cover' there is for such Preference Capital as regards assets and earnings; and where the Preference Capital is cumulative as to dividend, the arrears of dividend, should the profits not permit of the dividend being promptly paid, become correspondingly heavy, and these arrears would have to be met out of subsequent profits before any dividend could be paid on the Ordinary Share Capital.

It would also appear that the amount of the Debenture Capital, namely £100,000, is unduly large, considering that the land, buildings, etc. (that is to say the fixed assets), which would be specifically charged as security for the Debentures, did not amount in value, at the date of the inception of the Company, to more than £100,000.

Let it be assumed that for the first five years of the Company's existence, namely 1920-1924 inclusive, the business continued to be successful, and that the profits earned per annum were equivalent to those which had been earned by the business previous to the inception of the Public Limited Company. In view of the fact that the business had adequate floating capital for its needs, the Directors distributed the whole of these profits in dividend. The fact that the Debentures were redeemable at the end of 1930, and also the fact that in the Company's Balance Sheet Goodwill stood at a substantial figure, would seem to call for a more conservative policy; for example, had the Directors utilized a portion of the profits each year in writing down the Goodwill item, or making a reserve against it, this would have strengthened the Balance Sheet,

as the intangible asset of Goodwill appearing on the Balance Sheet would gradually be reduced, and there would be correspondingly more floating assets in the business which would be available towards providing the funds to redeem the Debentures at the end of 1930

Let it be assumed that in 1925 the prosperity of the Company's business very much declined, and that this decline continued during the years 1926, 1927, and 1928. Let it be assumed that the adverse results were partly due to a decrease in the Company's turnover and partly to lower selling prices obtained for the Company's products.

The following Balance Sheet shows the position of the Company at the end of 1928:

| Share Capital authorized and issued: 200,000 8% Cumulative Preference Shares of £1 each, fully paid £200,000 100,000 Ordinary Shares of £1 each, fully | Goodwill at cost £75,000 Land, Buildings, Plant, etc., at cost, less de- preciation per last Bal- ance Sheet £115,000 Additions during 1928 8,500 |
|--|---|
| paid 100,000 | 123,500 |
| • | Less depreciation |
| 300,000 | written off in |
| (Note: The Cumulative | respect of 1928 6,500 |
| Dividend on the Prefer- | 117,000 |
| ence Capital has been | Stock in hand and work |
| paid up to the 31st De- | in progress 128,000 |
| cember, 1925. Amount | Book debts, etc 66,000 |
| of arrears $£48,000$) | Cash at Bank and in hand 9,000 |
| , | Profit and Loss Account: |
| 100,000 6% Mortgage | Net loss for |
| Debentures (redeem- | the year 1926£10,000 |
| able on 31st December, | Net loss for |
| 1930) 100,000 | the year 1927 12,000 |
| Sundry Creditors 23,000 | Net loss for |
| | the year 1928 9,000 |

| Brought forward £423,000 | Brought forward £31,000 £395,000 Less: Credit balance on Profit and Loss Account at 31st December, 1925, after meeting dividend on the Cumulative Preference Shares in respect of that year £3,000 28,000 |
|--------------------------|---|
| £423,000 | £423,000 |

It will be seen from the above Balance Sheet that, unless there is a substantial improvement in the trading results in the near future, the Company's position is likely to be precarious. To some extent, of course, this is due to the policy of the Directors in not retaining in the business some portion of the profits during the first five years of the Company's existence when trading results were satisfactory. To a considerable degree, however, the Company's difficult situation arises from the fact that the creation of the Debenture debt at the inception of the Company was open to criticism both as regards the size of the debt and also as regards the terms—that is to say, the fact that the Debentures are redeemable at the end of 1930. If, for reasons which are not apparent, it was considered at that time desirable to create £100,000 Capital in the form of Debentures, having a life of only eleven years, there should have been some stipulation whereunder a fund would have been accumulated out of annual profits in order to meet wholly or substantially the redemption of the Debentures at their maturity.

It will be noticed that at the date of the Balance

Sheet the Company is not actually short of floating capital, this being due to the fact that the decline in turnover has meant that less floating capital was required for purposes of the business. As already mentioned, the Stock, Book Debts, and Cash, less the Creditors at the inception of the Company, amounted to £,225,000 whereas at the 31st December, 1928, they only amount to £180,000—namely: Stock and work in progress £128,000 Book Debts 66,000 Cash 9,000 £,203,000 Less: Creditors 23,000

£,180,000

The general effect, however, of a decline in turnover in the case of a manufacturing business is a decline in the margin of net profits. In other words, as the turnover falls the percentage of net profit to turnover is also likely to fall, this being due to the fact that many expenses (commonly referred to as 'overhead charges') remain more or less constant, irrespective of turnover.

It therefore appears not unlikely that, if the Company's turnover were to decline still further, greater losses would be incurred, which means that floating capital will have been eaten up. If, on the other hand, the Company can increase its turnover, this, while satisfactory from the point of view of enhanced earning power, usually means that more floating capital is required, as a greater stock needs to be carried, the work in progress is higher, and the book debts are greater. It is difficult to see where this Company would be able to obtain this additional floating

capital, bearing in mind that its fixed assets are charged as security for the Debentures, and that the Debenture holders have the right to call for repayment on the 31st December, 1930. It is extremely unlikely that a Bank would advance any money to the Company, and the only means of obtaining Capital would seem to be through the shareholders, who might be induced to subscribe more Capital in order to protect, in some measure, the Capital which they had already embarked in the business, and which at the 31st December, 1928, would be worth very much less than its nominal value.

The objections to the method of capitalization which the above Company has adopted are brought into greater prominence if the situation is examined in the light of what would have happened had a different capitalization been decided upon at the outset.

Let it be assumed that when the Company was formed in 1920 the capitalization had been as follows:

It is suggested that as there is no Debenture issue, and as the Ordinary Share Capital is considerably greater than the Preference Share Capital, it would be sufficient if the rate of Cumulative Dividend attached to the Preference Capital were fixed at 7%.

As compared with the method of capitalization actually

226 PUBLIC COMPANIES AND THE INVESTOR adopted, the alternative method described above has the following advantages:

- (a) There is no Debenture issue, and therefore nothing is payable to holders of any of the Capital unless profits are available for the purpose. Interest on Debentures, it will be remembered, is payable whether there are profits or not.
- (b) No portion of the Capital is temporary: in other words, the Preference Shareholders cannot (as the Debenture Holders in the capitalization scheme actually adopted were able to do) call for redemption of their capital at a certain fixed date.
- (c) The Preference Shares are very amply covered as regards tangible assets. As will be remembered, the tangible assets, less liabilities, at the inception of the Company amounted to £325,000, which is more than twice the amount of the Preference Share Capital. This enables the Preference Share Capital to be issued carrying a lower rate of fixed dividend (namely 7%) than was the case under the scheme adopted (namely 8%).

| In the scheme | of capitalization | actually | |
|----------------------|-------------------|-----------|----------|
| adopted the tangible | net assets | | €325,000 |
| were represented by | Debenture Capit | al to the | |
| extent of | | | 100,000 |
| leaving a balance of | | | £225,000 |
| which was not very m | uch more than the | nominal | |
| amount of the 8% | Cumulative F | reference | |
| Capital, namely | | | £200,000 |

Let it be assumed that, having adopted the revised method of capitalization, the Directors pursue just the same financial policy in 1920-24 inclusive as was previously described—that is to say, that the whole of the profits were distributed in dividends.

As regards the years 1925-28 inclusive, it will be remembered that, under the capitalization arrangements which the Company did adopt, the profits of the year 1925 were sufficient to meet the Debenture interest, and also the Cumulative Preference Dividend in respect of that year, and to leave a balance to be carried forward of but that in respect of the years 1926, 1927, and 1928 there were shown, after meeting Debenture interest, the following losses:

£3,000

| 1926 | • • | | £10,000 |
|------|---------|---------|---------|
| 1927 | | • • | 12,000 |
| 1028 | | | 0.000 |

31,000

There was therefore a debit balance on Profit and Loss Account at 31st December, 1928, as shown by the Balance Sheet set out above, of .. £28,000

If, however, the Directors had adopted the alternative scheme of capitalization, the position in regard to the year 1925 would have been that no Debenture interest would be payable, and in this respect there would be a saving of

£6,000

Further, the dividend on the Preference Shares in respect of that

| Bayear, instead of being 8% on £200,000, | ought forward £6,000 |
|--|----------------------|
| namely | |
| would have been 7% on £150,000, or | 10,500 |
| There would, therefore, have | |
| been a saving in respect of Preference | |
| Dividend of the difference, namely | 5,500 |
| | 11,500 |
| Therefore, instead of there being | |
| a credit balance of only | 3,000 |
| on Profit and Loss Account at 31st | |
| December, 1925, as mentioned above, | |
| there would have been a credit | |
| balance of | £14,500 |

It would be reasonable to assume that, in view of the comparatively poor results of 1925, the Directors would not distribute any portion of this £14,500 in Dividend on the Ordinary Share Capital.

As regards the years 1926, 1927, and 1928, the net losses as shown would, in each case, be reduced by £6,000, namely the amount of the Debenture Interest, which, under the alternative scheme of capitalization, would be non-existent. There would, therefore, be a saving of £18,000, and in consequence, instead of the losses of these three years amounting collectively to £31,000, they would only amount to £13,000.

The position, therefore, as regards the balance on Profit and Loss Account at 31st December, 1928, would be that, instead of there being a debit of £28,000, there would be a credit

of £1,500, namely a Credit balance at 31st December, 1925, as mentioned above, of ...

Less total losses of the years 1926-28 inclusive

£,14,500

| as mentioned above | •• | •• | •• | • • | 13,000 |
|---------------------------|----------|----------|-----------|-------|--------------|
| Credit Balance on P | rofit an | d Loss | Accour | nt at | |
| 31st December, 19 | 28 | • • | •• | • • • | £1,500 |
| The effect of the d | lifferen | ce betw | een a d | ebit | |
| balance on Profit and I | loss Ac | count o | f | | £28,000 |
| and a credit balance of | •• | | | | 1,500 |
| is that there would be | more flo | oating a | assets in | the | |
| business to the extent of | of | | | | $f_{20.500}$ |

and these floating assets would be available for additional floating capital if the business required it, which it would certainly do if an expansion in the output were to take place subsequently to the 31st December, 1928.

Summarizing the position, therefore, one notes that, under the scheme of capitalization actually adopted, the Company finds itself at the 31st December, 1928, with no floating capital surplus to its immediate requirements, and also with the necessity of finding within two years the sum of £100,000 in order to redeem its Debenture debt. Under the alternative scheme, however, the Company is not faced with having to redeem any of its Capital, and, further, it has in its business certain floating capital surplus to its requirements. This floating capital will stand it in good stead if its turnover should again expand, or, alternatively, it will enable it to withstand for a time further net losses without its being crippled for lack of liquid resources. Moreover, the Company could certainly obtain accommodation from its Bankers as all its Assets are free from any charge.

The Company's Balance Sheet at the end of 1928, had the alternative scheme of capitalization been adopted, would appear as follows:

| (Note: The Cumulative Dividend on the Preference Capital has been paid up to the 31st December, 1925. Amount of arrears £31,500) Sundry Creditors 23,000 Profit and Loss Account Credit balance at 31st December, 1925, after meeting the dividend on the Cumulative Preference Shares in respect of that year £14,500 Less: Net loss for: 1926 £4,000 1927 6,000 1928 3,000 13,000 1,500 £424,500 | Share Capital Authorized and Issued: 150,000 7% Cumulative Preference Shares of £1 each, fully paid £150,000 250,000 Ordinary Shares of £1 each, fully paid 250,000 | in progress 128,000 Book debts, etc 66,000 Cash at Bank and in |
|--|--|--|
| Profit and Loss Account Credit balance at 31st December, 1925, after meeting the dividend on the Cumulative Preference Shares in respect of that year £14,500 Less: Net loss for: 1926 £4,000 1927 6,000 1928 3,000 1,500 | (Note: The Cumulative Dividend on the Preference Capital has been paid up to the 31st December, 1925. Amount | |
| - | Profit and Loss Account Credit balance at 31st December, 1925, after meeting the dividend on the Cumulative Preference Shares in respect of that year £14,500 Less: Net loss for: 1926 £4,000 1927 6,000 1928 3,000 13,000 | |
| | | |

APPENDIX D

'PRO FORMA' BALANCE SHEET ILLUSTRATING CERTAIN OF THE POINTS REFERRED TO IN CHAPTER IV ON PUBLIC COMPANY FINANCE

BALANCE SHEET, 31st DECEMBER, 1928

| Share Capital Authorized and Issued: 100,000 Shares of £1 | Land, Buildings, Plant and Machinery, less Depreciation £90,000 |
|---|--|
| each, fully paid£100,000 6% 10-year Debenture Capital, repayable on 31st December, 1930 25,000 | Stock-in-Trade and Work in progress, at or under cost 40,000 Book debts, etc., less re- |
| Trade Creditors for Supplies, etc. £18,000 | serve for doubtful debts 16,000 |
| Other Creditors 3,000 General Reserve Account 10,000 Profit and Loss Account | , • . |
| Undistributed Balance, | £9,500) 9,000 Cash at Bank and in |
| representing: Net profits of the year 1928 . £20,000 Less: Dividends distributed prior to the 31st December, 1928 17,000 | hand 4,000 |
| 3,000 | |

£159,000

The expressions 'permanent Capital' of the Company, and 'temporary Capital'—or, to use another phrase, 'non-permanent Capital'—have reference to the class of capital subscribed and not to the classes of assets which

represent such capital. Therefore the permanent Capital of the Company whose Balance Sheet is shown above would be the Share Capital, and the non-permanent Capital would be the short-term Debenture Capital. When figures are quoted in connection with permanent Capital or non-permanent Capital, they usually refer to the nominal value of such capital, and not to its real value.

The Share and Debenture Capital is, of course, represented by assets of various classes, less liabilities. The book value of the assets, less liabilities, may be more, or it may be less, than the nominal amount of the Company's issued Capital. For example, in the above Balance Sheet:

The above £13,000 is, of course, represented by the total of the balances on General Reserve Account and on Profit and Loss Account, which balances represent profits of past years retained in the business instead of being distributed in dividend, and therefore constitute an accretion to the Company's Assets.

Further, of course, the real value of the total Assets, less Liabilities, of the Company may be greater, or it may be

The book value of the Capital employed in

An expression frequently used in connection with Companies' businesses—and, indeed, in connection with all businesses—is 'Capital employed.'

| the case of the business owned by the Company | | | | |
|--|--|--|--|--|
| whose Balance Sheet is set out above is£138,000 | | | | |
| and the capital consists of Assets totalling£159,000 | | | | |
| less Liabilities totalling 21,000 | | | | |
| Cros ooo | | | | |
| £138,000 | | | | |
| Such Capital has, of course, been provided as follows: | | | | |
| By Shares £100,000 | | | | |
| By Debentures 25,000 | | | | |
| By the retention of profits in the business, | | | | |

represented by the sums at the credit of the General Reserve Account and Profit and Loss Account 13,000

C198 000

As already explained, the real value of the Capital employed may be more, or it may be less, than the book value. In this particular case, as previously mentioned, the real value is greater than the book value.

Incidentally, it may be mentioned here that it would not be correct to regard the Goodwill as being part of the 'Capital employed' in the business. In this particular case, the value of the Goodwill has been created by the Company's own efforts. Even if, however, the Company had acquired the business at a time when there was a valuable Goodwill in it, and it paid a specific portion of the purchase

price in respect of such Goodwill, this Goodwill would not ordinarily be regarded as an asset used in the business. The payment for Goodwill is really a premium paid by reason of the business having a high earning capacity when measured by reference to the Capital employed.

Another expression frequently used is 'Capital employed in the business.' In computing this, the Stock Exchange investments would, in the particular case exemplified in the Balance Sheet shown above, be excluded, as they are presumably surplus to the requirements of the business. In certain cases such investments might be considered as Capital employed in the business, as, for example, where investments were made temporarily and it was known, or believed, that the business would shortly again require the Capital locked up in the securities and that the securities would therefore have to be sold.

A somewhat similar point occasionally occurs in connection with cash at Bank. A business always requires a certain balance with its Bankers, and to that extent, although the money may be on Current Account and be earning nothing, it nevertheless in effect forms part of the 'Capital employed.' If, however, a business has for a considerable time a very large credit balance with its Bankers, a portion of this may, in a proper case, be regarded as not being 'capital employed in the business.'

Other expressions often used in connection with Balance Sheets of Limited Companies are 'Fixed Capital employed' and 'Floating Capital employed.' These expressions do not refer to the Capital subscribed—that is to say, to the Share and Debenture Capital—but to the Assets which represent such Capital.

The fixed Capital employed would be represented by

what are known as 'fixed Assets,' that is to say, land, buildings, plant, etc., or, in other words, assets by means of which the business is carried on.

The floating Capital employed would be represented by Floating Assets, less current Liabilities. Floating Assets are those in which the Company trades, and which are constantly changed in form and amount, such as book debts, cash balances, stock-in-trade, work in progress, etc.

Matters connected with Balance Sheets of Limited Liability Companies are dealt with much more fully in other parts of this book (Chapter VII and Appendix G): it was, however, thought necessary to submit the foregoing information in explanation of the matter contained in Chapter IV in order that the reader could turn to it immediately after reading Chapter IV.

APPENDIX E

'PRO FORMA' STATUTORY REPORT

Brief reference has been made in Chapter VI to the Statutory Report. The following is an example of a Statutory Report.

The Directors report as follows:

- (a) The total number of Shares allotted up to the 9th November, 1929, is 100,000 of £1 each, of which 50,000 have been allotted as fully paid up in consideration of the purchase of properties under an agreement, and 50,000 have been allotted for cash at par. In respect of the Shares allotted for cash, the sum of 5s. per Share has been called up.
- (b) The cash received to the 9th November, 1929, in respect of the Shares issued for cash is £12,230.
- (c) The following is an abstract of the receipts of the Company and the payments made thereout up to the 9th November, 1929.

RECEIPTS

PAYMENTS

| Cash received in respect of 50,000 Shares of £1 each, of which 5s. a Share has been called up Receipts on Revenue Account | , , | Cash paid on account of purchase price of properties under agreement of 2nd October, 1929 Preliminary Expenses—including Stamp and other duties Payments on Revenue Account | £5,000 2,376 1,237 |
|---|-----|---|--------------------------|
| | | | |

Carried forward £14,300

Carried forward £8,613

| RECEIPTS | | PAYMENTS | |
|-----------------|----------|------------------------|--------|
| Brought forward | £,14,300 | Brought forward | £8,613 |
| 3 0 | | Balance represented by | |
| | | Cash at Bank on De- | |
| | | posit and Current | |

posit and Current Accounts

£14,300

(d) The total amount of the Preliminary Expenses is estimated at £2,500.

(e) The names, addresses, and descriptions of the Directors, Auditors, and Secretary of the Company are as under. (Here would follow the respective names.)

We certify this Report

A. B. \nearrow Directors

14th November, 1929

AUDITORS' REPORT

D.

We hereby certify that so much of this Report as relates to the Shares allotted by the Company and to the Cash received in respect of such Shares and to the Receipts and Payments of the Company on Capital Account and otherwise is correct.

E. F. & Co. Chartered Accountants

14th November, 1929

Note—The Auditors' duty in regard to the Cash Receipts and Payments Account is, under the Companies Act, 1929, limited to items of Capital Receipts and Payments. But it is not unusual, where Revenue Receipts and Payments are made during the period and mixed with the Company's Capital transactions, for the Auditors to confirm all Receipts and Payments. To cover this wider examination the words 'and otherwise' are often inserted in the Auditors' Report as above.

APPENDIX F

NOTES ON THE CHIEF PROVISIONS OF THE COMPANIES ACT 1929 IN REGARD TO THE SUBMISSION OF ACCOUNTS

The Investor in a Public Company has the right to expect that the Company will comply with all the legal requirements in regard to the keeping and submission of Accounts. Primarily, therefore, these may be said to be matters of more direct interest to the officers of a Company (e.g. the Directors and the Secretary) than to the Shareholders. At the same time, it is desirable that the Investor should have some general idea of what the Companies Act provides in this connection, especially in so far as this affects information which ought to be supplied to him by the Directors, as, for example, that through the medium of the Balance Sheet. The following brief notes have, therefore, been prepared from the particular point of view of the Investor.

In the first place the Act provides that a Company shall keep 'proper books of account' with respect to certain classes of transactions (which need not be specified here); the definition, as is natural and proper under the circumstances, is a wide one, but does not enter into much detail. The Directors of a Company are therefore responsible for causing proper books of account to be kept.

The first 'account' which a Company has to submit to its Shareholders is the account which forms part of what is known as the Statutory Report. A new Company, within a certain time after it has obtained from the Registrar of

Joint Stock Companies a certificate entitling it to commence business, must forward to its Shareholders certain information, and must call a Meeting of the Shareholders to consider the information. In the main the particulars to be submitted concern the issue of the Company's Share Capital and the consideration for which such issue has been made. A form of a Statutory Report is set out in Appendix E, and no further reference to this document appears to be called for, except to say that the Investor should look at the Statutory Report and compare it with the Prospectus in order to see whether the amount due in respect of Share and Debenture Capital appears to have been paid up or whether large sums are unpaid and overdue. If the latter be the case, he should attend the Meeting and try to obtain a proper explanation.

Within eighteen months of a Company's incorporation, and subsequently once at least in each calendar year, the Directors are required to submit to the Shareholders at a General Meeting a Balance Sheet and Profit and Loss Account. The date to which these Accounts must be made up must not be more than nine months before the date of the Meeting, except that if the Company has interests abroad this period is extended to twelve months.

Not more than fifteen months may elapse between any two General Meetings.

A copy of the Balance Sheet, with the Auditors' report thereon, has to be sent out by the Directors of a Public Company to all Shareholders entitled to receive notices of General Meetings at least seven days before the date of the Meeting.

Prior to the passing of the Companies Act, 1929, there was, practically speaking, no attempt in the Acts regulating

the procedure of Joint Stock Companies to define how a Company's Balance Sheet should be drawn up.

From the point of view of the legislature it has, no doubt, been considered wise to limit, so far as possible, the making of regulations which might, in certain individual cases, interfere with the discretion of Directors in the administration of a Company's affairs. It must also be remembered that, so far as a Limited Liability Company is concerned, the Shareholders have, in the ultimate issue, the absolute control-vis-à-vis the Directors-over matters such as the amount of information which a Balance Sheet should disclose, or the form in which such document should be presented. It is true that the Balance Sheet is prepared and submitted under the supervision of the Board of Directors, but if the Board neglects to carry out the wishes expressed by a majority of Shareholders the latter have the power to elect another Board in its place, and by this means they can enforce their wishes.

The Companies Act, 1929, does, however, lay down certain regulations with which the Directors are required to comply in regard to the Balance Sheet. The Act provides that 'Every Balance Sheet of a Company shall contain a summary of the authorized Share Capital and of the issued Share Capital of the Company, its Liabilities and its Assets, together with such particulars as are necessary to disclose the general nature of the Liabilities and the Assets of the Company and to distinguish between the amounts respectively of the Fixed Assets and of the Floating Assets, and shall state how the values of the Fixed Assets have been arrived at.'

It will be noticed that the wording of the section above quoted is very general; that there are good reasons for this will be evident to anyone who has had much experience of

the framing or reviewing of Balance Sheets of public Companies.

Comments on what constitute Fixed and what constitute Floating Assets will be found in Chapter VII.

In various other parts of the Companies Act, 1929, there are specified certain special items or classes of item which are required to be shown separately or in a special manner on the Balance Sheet.

These items are as follows:

Items appearing on the Assets side of the Balance Sheet

Preliminary expenses incidental to a Company's formation, until written off,

Expenses in connection with any issue of Share or Debenture Capital, until written off,

Commission paid or discount allowed in respect of any Shares or Debentures, until written off,

Goodwill, Patents, and Trade Marks,

Loans made to persons to enable them to acquire Shares in the Company,

Loans to Directors or other officials,

Shares in Subsidiary Companies,

Amounts owing by Subsidiary Companies to the Parent Company.

Items appearing on the Liabilities side of the Balance Sheet

That portion of the issued Capital of the Company which consists of Redeemable Preference Shares.

Debentures which have been redeemed but which can be re-issued.

Amounts owing to Subsidiary Companies.

¹Prior to the passing of the Companies Act, 1929, it was not legal to issue redeemable shares.

The reader who desires more information about these matters must turn to the Act itself. There is, for example, a special definition in the Act of what constitutes, in the above connection, a 'Subsidiary Company.'

Prior to the passing of the Act of 1929 there was no obligation on a Company to submit a Profit and Loss Account to its Shareholders; and even now the Profit and Loss Account need not be circulated to the Shareholders with the Balance Sheet, so long as it is available for inspection at the meeting itself.

No stipulations are embodied in the Act as to the form which the Profit and Loss Account shall take, nor as to the amount of information which it shall disclose, except that the total remuneration paid to Directors is required to be stated either in the Profit and Loss Account or elsewhere. In this latter connection an exception is made in regard to remuneration paid to a Managing Director, and also in regard to remuneration paid to a Director in respect of any salaried employment or office—that is to say, as distinct from fees paid to him as a Director. These provisions in regard to Directors' remuneration apply also to remuneration which the Directors of a Company may receive as Directors of a Subsidiary Company.

The Directors in submitting a Company's Balance Sheet have also to furnish with it a report stating, inter alia, the amount recommended to be paid by way of Dividend, and the amount proposed to be carried to any Reserve Account to be shown on the Balance Sheet. These last few words may have an important significance, as there seems, by inference, to be excluded from this section of the Act any appropriations which Directors may, in the interests of the Company, decide to make to an undisclosed—i.e. a hidden—reserve. The principle of the creation of

undisclosed reserves by public Companies at the discretion of the Board is one which is sanctioned by usage, and is to be generally commended. A power of this description may, of course, be misused by incompetent Directors, or abused by unscrupulous Directors. In the vast majority of cases, however, the action taken is in the best interests of the Shareholders.

Reference has been made above to Subsidiary Companies. One of the clauses in the Act of 1929 requires a statement to be annexed to a Company's Balance Sheet showing how the Profits and Losses of Subsidiary Companies have been dealt with, and how, if at all, they have been taken into consideration in drawing up the Accounts of the Holding Company. It should be mentioned that the Act does not require the figures representing the Profits or Losses of Subsidiary Companies to be quoted, either individually or collectively, but merely a description to be given of how the situation has been dealt with. It will be appreciated that in a case where a Holding Company owns the whole of the Share Capital of a Subsidiary Company the Profits and Losses of the latter Company are, in effect, the Profits and Losses of the Holding Company. At the same time, from the legal point of view, the Subsidiary Company is an entirely separate and distinct entity.

The same section of the Act (in reference to Profits and Losses of Subsidiary Companies) provides that if an Auditor's report on the Balance Sheet of a Subsidiary Company is qualified in any way the statement annexed to the Balance Sheet of the Holding Company must also contain particulars of the manner in which the report is qualified.

APPENDIX G

EXAMPLES ILLUSTRATING (i) ABBREVIATED BALANCE SHEET (ii) FULL BALANCE SHEET (iii) LIMITATIONS OF A BALANCE SHEET

In this Appendix will be found

- (a) A specimen of the Balance Sheet of a Company in abbreviated form.
- (b) The same Balance Sheet re-drafted in order to afford much fuller information.
- (c) Notes on various matters which are or may be of considerable importance from the point of view of anyone attempting to review the financial position and prospects of the Company, but which would not be apparent, even from a perusal of the detailed Balance Sheet referred to under (b) above.

The objects of this Appendix are:

Firstly, to show the great difference between the information disclosed in an abbreviated Balance Sheet and the information disclosed in a full Balance Sheet; and,

Secondly, to illustrate the limitations to which, by its very nature, a Balance Sheet is subject, no matter how 'full' and complete it may appear.

EXAMPLES ILLUSTRATING ABBREVIATED AND FULL BALANCE SHEETS AND THEIR LIMITATIONS

BALANCE SHEET 30th JUNE, 1929 (in abbreviated form)

| To Share Capital Authorized and Issued 500,000 Shares of £1 each, fully paid | Ç500 ,00 0 | By Land, Buildings, Plant, Machin- ery, etc., at cost less depreciation | £300,478 |
|--|-------------------|---|----------|
| " 5% IST MORTGAGE DEBENTURES (secured on the Assets) | 158,000 | " Goodwill, at cost less amounts written off | 160,000 |
| "SUNDRY CREDITORS, AND SPECIFIC RESERVES | 25,820 | "INVESTMENTS, at cost, less amounts written off (including Shares in Subsidiary Companies £118,000, and | |
| " DEBENTURE SINK- ING FUND ACCOUNT | 42,000 | Loans to Subsidiary Companies £12,834) | 237,342 |
| " GENERAL RESERVE ACCOUNT | 48,000 | ,, STOCK-IN-TRADE AND WORK IN PRO- GRESS, at or under | |
| " Profit and Loss Account | 39,476 | cost | 54,87€, |
| | | "Debtors, Payments in Advance, etc | |
| | | " Cash | 27,34c |
| * | (813,296 | | £813,296 |

NOTE-This Ralance

NOTES

Although the detailed Balance Sheet set out in the folded sheet is in a very full form, it must not be assumed that it affords all material information necessary to enable a person to judge of the financial position of the Company. This is not in any way the fault of the Balance Sheet; it arises by reason of the fact that Balance Sheets have limitations.

The following notes indicate points which are, or may be, of very considerable importance, but which are not apparent from the Balance Sheet.

Freehold Land and Buildings

These are stated in the Balance Sheet at cost, less depreciation written off. Presumably the depreciation would be written off the Buildings as these are subject to deterioration by reason of wear and tear, whereas the land is not. The question arises as to whether there is any Freehold Land surplus to the Company's immediate or anticipated requirements; and, if there is, how the value of such Land compares with its cost to the Company. It is conceivable that the Company might have some Land which it acquired many years ago at a relatively trivial cost, and which it could to-day sell for a very large figure without in any way prejudicing or interfering with its business.

As regards the Leaseholds, it will be seen that if the same scale of depreciation is applied to these in future years as has been applied in regard to the year to 30th June, 1929, the asset will be written out of the books within three years. Primd facie the item is a small one and might not appear to call for comment. But if, as a matter of fact, an important part of the Company's business is carried on in these Leasehold Premises, and if, on the expiration of the Lease,

no renewal can be obtained on reasonable terms, a difficult situation may conceivably arise, particularly if no other suitable premises could be obtained.

The Company, owing to its policy of not distributing the whole of its profits in dividend, has been able to accumulate substantial investments in Stock Exchange securities, which could, if necessary, be sold to provide funds for the purchase of a new lease. But, as mentioned above, it may not be found practicable to purchase a new lease suitable to the business.

Fixed Plant and Machinery

It is to be assumed that the depreciation is calculated on a scale which is designed to write off the book cost of the various items of Plant by the time the economic life of such items has disappeared. On the face of it, it may appear that if such is the case no important considerations in regard to this item can arise. There is, however, this very important circumstance in connection with items representing Fixed Assets which appear in Balance Sheets. These items are frequently composed in part of pre-war expenditure; in part of expenditure during the latter half of the war and the three or four years succeeding it when costs were on a very high scale; and in part of expenditure at a time when prices were round about their present level. Merely for illustration purposes it may be suggested that a Fixed Asset which could be bought for £1 in 1913 might cost £2 10s. if bought within 1917 and 1921, and £1 15s. if bought, say, in 1928.

From the Balance Sheet there is nothing to indicate what proportion of the Asset figure appearing in the books under the heading 'Fixed Plant and Machinery' consists of pre-war expenditure; what proportion consists of what may be called 'boom-time' expenditure; and what proportion

consists of expenditure when prices were at or about their present level.

If, to take an extreme case, a very large proportion of the Fixed Plant and Machinery in existence at 30th June, 1929, consisted of Plant purchased before the war, and if in a few years' time a large portion of that Plant becomes worn out, the Company will have to expend relatively a very large sum of money in acquiring new Plant to take its place. It is true that the current charge for depreciation may be sufficient to extinguish the book value of this prewar Plant by the time that its life is over; but immediately the pre-war Plant goes out of existence and is replaced by new Plant which costs very much more than the similar pre-war Plant cost, the annual charge which the Company will have to make in respect of depreciation in order to write off the cost of the new Plant within the period of its economic life will be much larger than has been the case in the past. This means that the Company's disclosed annual profits would be relatively smaller.

Goodwill

It is to be appreciated that the figure appearing in the Balance Sheet does not necessarily represent the current value of the Goodwill of the Company's business; it merely represents what the Company paid for Goodwill in the first place, less any sums which the Company has chosen to write off this item out of its annual profits. If anyone endeavours to assess the value of the Company's Goodwill he would not confine himself to a review of the last Balance Sheet only. The most important point which he would consider is what is the earning capacity of the Company. In this connection he would desire to know what the profits of each of a past series of years were; what the exact nature of the Company's business was; what relation the profits of each year bore to

the turnover of that year; whether the profits as shown on the Company's annual Balance Sheet and Profit and Loss Account had always been arrived at on uniform lines; and he would then have to consider to what extent these past profits might be considered as a guide to future probabilities.

Shares in Subsidiary Companies at Cost

There is nothing in the Balance Sheet which indicates what may be the present value of the Shares in the Subsidiary Companies. In this connection one would want to know what the Assets and Liabilities of these Companies were, and also what was their earning capacity. It will be observed from the note on the Balance Sheet that the Subsidiary Companies have been making profits, but that such profits have not been taken credit for in the Accounts of the Holding Company except to the extent to which the latter has received a dividend declared out of such profits. There is therefore no indication on the face of the Balance Sheet either as to the total profits earned by Subsidiary Companies for which the Holding Company could, on economic grounds, take credit, or as to the amount of dividends from Subsidiary Companies for which the Holding Company has, as a matter of fact, taken credit. The bulk of the profit shown, or alternatively very little of it, might have been earned by the Subsidiary Companies.

Trade Investments

It will be noted that these appear in the Balance Sheet at their cost to the Company, namely £46,184. There is no indication as to what their present value to the Company may be. One presumes that if the Directors had been of opinion that their present worth to the Company was substantially less than their cost, they would have applied

a portion of the profits to write down this item. On the other hand, of course, it may be the case that these Investments are at the present time of infinitely greater value than the figure at which they appear in the Balance Sheet. There is no indication of the nature of these Investments—in other words, what are the types of business which the Companies in question own, and what relations, if any, exist between these businesses and the business of the Company holding the Investments.

General Comments

In alluding in this Appendix to certain information which will be very valuable to an Investor who is thinking of embarking his money in a public Company, but which would not be included in the published Accounts of the Company, it must not be assumed that the information ought to be made available. Much of it might be of considerable use to the Company's competitors, and it could not be made available for Shareholders without a grave risk that it would also find its way into competitors' hands.



APPENDIX H

(i) NOTES ON POSITION AS DISCLOSED BY THE STRONG BALANCE SHEET.

This Balance Sheet, considered in conjunction with the Profit and Loss Account, shows a position of very considerable strength.

As regards the Fixed Assets, it will be seen that the figure of Goodwill has, by a series of appropriations from profits, been reduced to what is, under the circumstances, a negligible amount. If the earnings of the Company for the year 1929 can be taken as typical of a normal year, there is (as will afterwards be indicated) a very substantial real value in the Company's Goodwill.

As regards the Land and Buildings and the Plant and Machinery, it will be noted that depreciation has been written off such of these assets as are subject to wear and tear. It is difficult to form a definite opinion whether the depreciation provided is adequate, but, as will be seen, between £31,000 and £32,000 was charged in arriving at the profits for the year 1929, which is substantial. It will be noticed from the Balance Sheet that the depreciation written off Plant and Machinery in 1929 amounted to about $7\frac{1}{2}\%$ on the book value of the Plant in existence at the beginning of the year.

It will also be seen that the Floating Assets employed in the business (namely Stock-in-Trade and Work in Progress, and Book Debts, etc.) are very substantial and are considerably in excess of the Floating Liabilities. The Stock-in-Trade,

etc., and the Book Debts, etc., amount in total to over £200,000, while the Sundry Creditors and Specific Reserves total less than £35,000. It is true that there is a Debenture debt, but this, by means of the operation of the Cumulative Sinking Fund, has been reduced to the small figure of £26,000, which, by the further operation of the Sinking Fund, will, in the course of the next two years, disappear entirely.

In addition to the liquid position disclosed by the above figures, it will be observed that the Company has cash at Bankers of about £18,000 and also outside Investments, which stand in its books at about £74,000, but have a market value at the date of the Balance Sheet of about £77,000.

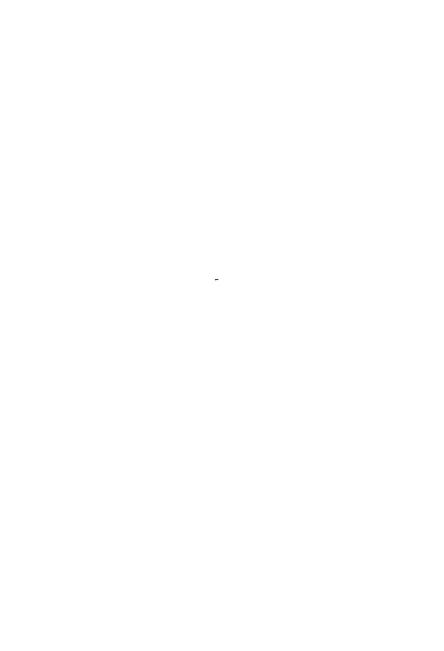
It will be noted that Free Reserves are very large, consisting of:

| Debenture Sinking Fund | • • | | | £174,000 |
|---------------------------|------------|-------|-----|----------|
| General Reserve Fund | | | | 75,000 |
| Undistributed Balance on | Profit and | Loss | Ac- | |
| count (out of which a | final Div | idend | for | |
| 1929 will presumably be 1 | paid) | | | 67,742 |

£316,742

In all, therefore, the Company's Free Reserves total to a figure equivalent to more than three-fifths of the total Share Capital, and there is, further, the undisclosed Reserve arising from the fact that the Goodwill of the Company's business appears in the Balance Sheet at the relatively small figure of £15,000.

Turning now to the Profit and Loss Account, it will be seen that this shows a credit balance in respect of the year 1929 of about £66,000. It should, however, be noted that this balance is arrived at after deducting the Interest and



Sinking Fund charge in respect of Debentures, amounting to £14,000 and after writing off from Goodwill the sum of 5,000

The charge for Interest and Sinking Fund on the Debentures will, after the next two years, disappear entirely, as the Debentures will all be redeemed; and the amount written off Goodwill is purely an appropriation of profits. It may, therefore, fairly be said that, if the year 1929 can be taken as a criterion, the real earning capacity of the Company, instead of being about £66,000, is about £85,000, which represents a very satisfactory yield on the actual Capital employed in the business—that is to say, the Capital represented by the Fixed and Floating Assets less the Liabilities. On this basis the Company's business has a valuable Goodwill.

Summarizing the position therefore, the Company's earning capacity is very satisfactory, and its resources are such that it has substantial funds to permit of additional expenditure on Works and Plant should this be necessary, without having to call on the Shareholders or others to provide additional Capital. Further, the existence of these large floating resources would enable the Company, should its business fall on evil days, to sustain substantial losses before it could be crippled for lack of Floating Capital.

(ii) NOTES ON POSITION AS DISCLOSED BY THE WEAK BALANCE SHEET (see folded sheet opposite)

This Balance Sheet, considered in conjunction with the Profit and Loss Account, shows a very unsatisfactory position.

As regards the Fixed Assets, it will be seen that the Goodwill appears in the Balance Sheet at the very large sum

which the Company originally paid for it, whereas, if the trading results of the year 1929 can be taken as a criterion, the Goodwill has no present value.

The Land and Buildings, it will be noticed, appear at cost, no depreciation having apparently ever been written off the Buildings. It may, of course, be the case that the buildings, as such, are worth more than the amount which the Company paid for them; on the other hand, of course, Buildings are subject to deterioration from year to year, and also, in some cases, to obsolescence.

In the case of the Plant and Machinery, it will be noted that depreciation has been provided, but the question remains whether such depreciation is adequate. It will be noted that the sum provided for depreciation in respect of 1929 is less than 5% on the book figure of the Plant and Machinery at the 31st December, 1928, and, bearing in mind that such book figure is a written down one, the rate, considered as a rate, is certainly not on the high side: much may depend, of course, upon the class of the Plant and Machinery, and also upon the question of whether it has been kept up to a proper state of efficiency by maintenance expenditure charged each year in arriving at the profits.

To turn now to the Floating Assets, it will be observed that the Stock-in-hand and the Work in Progress and the Book Debts, etc., amount together to about £78,000, and that these Floating Assets are in total less than the amount of the Floating Liabilities, which latter total, as shown by the Balance Sheet, something over £77,000. The question arises in this connection whether the Company's Trade Creditors Accounts are promptly paid when rendered or whether the total of £32,000 under the head of 'Sundry Creditors' includes some Creditors' Accounts, the payment of which has fallen into arrear. Further, the existence of

Bills Payable to the substantial amount of £15,500 may be an indication that the Company finds itself short of Floating Capital.

With respect to Liabilities generally, it will be noted that the Company has a very large Debenture debt which is repayable on the 31st December, 1931. It is difficult to appreciate, from the position disclosed by the Balance Sheet, how the Company will be able to redeem this debt on maturity. Clearly it has no Assets surplus to the requirements of its business out of which it could do this, so that the only means by which the debt could be redeemed would be by the issue of Debenture or Share Capital to replace it. Having regard to the financial position of the Company and to the unsatisfactory trading results, any new Capital would presumably be very difficult to obtain.

As regards immediate liquid resources, it will be seen that the cash at Bank is small, and the Company has obtained certain loans from its Bankers by pledging as security warrants representing the title to certain of its Stocks. To what extent the Company has further documents constituting the title to its Stocks on which the Bank would be willing to make advances one does not know.

If, for example, the year 1930 were to show results similar to that of the year 1929, the Company's liquid resources would be further depleted by about £19,000, arrived at as follows:

| There would be an assumed net loss for the | ; |
|--|---------|
| year of about | £14,000 |
| But this loss is arrived at after making a charge, | • |
| namely | 11,000 |

in respect of depreciation of Plant and Machinery which does not represent an actual outgoing.

3,000

To this outgoing would further have to be added anything which the Company spent during 1930 on additions to Buildings, Plant and Machinery. The additions under this head in 1929 amounted to about £16,000. If, for example, similar additions were made during 1930, this would entail a further drain on resources of

16,000

Making total net depletion of liquid resources in 1930 of

.. £19,000

One would assume that under the circumstances the Company would hesitate to embark on any capital expenditure in 1930: but for the moment it has been presumed that it would continue the policy followed in 1929 in this connection.

To summarize the position, therefore, it may be said that, unless the Company's operations in 1930 show a result very much better than that for 1929, and unless the Company restricts its capital expenditure the position at the end of 1930 will be precarious, not to say desperate. And, further, even if the business should improve substantially in 1930, such a result, while satisfactory in itself, may mean that the business will require additional Floating Capital. In other words, if the Company's output in 1930 is substantially greater than its output in 1929, it is not unlikely that the amount of the Stock-in-hand and Work in Progress, and also the total of the Book Debts, may grow—that is to say, more floating resources will be needed. The provision of these resources will be very difficult.



APPENDIX I

COMPARISON OF BALANCE SHEETS AND PROFIT AND LOSS ACCOUNTS OVER A SERIES OF YEARS

It will be appreciated that the information afforded by, and the deductions which can be drawn from, a Company's Balance Sheet are limited, *inter alia*, by reason of the fact that the Balance Sheet only exhibits the financial position of the Company as at a particular moment of time; and the Profit and Loss Account submitted with that Balance Sheet merely shows the result of the trading operations for a certain financial period (usually a year) ended on the date of the Balance Sheet.

Considerably more light can frequently be thrown on the position if the Balance Sheets and Profit and Loss Accounts of a Company can be compared over a series of years.

With the object of illustrating this point, there will be found on the folded sheets of this Appendix statements summarizing the Balance Sheets and Profit and Loss Accounts of two Companies over a period of six years, from which statements valuable information can be gleaned as to the trend of events during the period. The first statement shows the position of a Company (called Company A) where the trend is unfavourable, and the second statement shows the position of a Company (called Company B) where the trend is favourable.

NOTES ON THE ACCOUNTS OF COMPANY A

It will be noted that the book value of the tangible Fixed Assets appearing in the this Balance Sheet—namely

Freehold Land, Buildings, Plant, and Machinery—shows a distinct tendency to increase from year to year, in other words, the additions made during each year exceed the items written off each year in respect of depreciation. With respect to the sums written off for depreciation, it will be noted that these for the first two years of the series are substantially higher than those relating to the remaining years, and this in spite of the fact that, as mentioned above, the net balance on the Fixed Assets Account shows a tendency to increase. One is therefore inclined to suspect either that the sums written off for depreciation in the first two years were in excess of the needs of the case, or that the charges for depreciation in the remaining years are inadequate.

It will be seen that no reduction in the book figure of Goodwill has taken place by means of appropriation from profits during the last four years of the series.

Floating Assets employed in the business, that is to say Stock-in-Trade, Work in Progress, Book Debts, and Payments in Advance, show a slight tendency to increase rather than to decrease (looking at the period as a whole), which, in an ordinary case, would lead one to imagine that the Company's business was expanding. On reference, however, to the Profit and Loss Account, it will be seen that the profit carried from the Trading Account—that is to say, the profit before charging Directors' remuneration, before making provision for depreciation, and before charging interest on Debentures, etc.—shows, broadly speaking, a regular and marked decline during the six years. It therefore seems apparent either

(a) that the volume of the Company's business, i.e. the total of the gross sales, has been maintained or has even

increased, but that the percentage rate of the profit earned thereon has declined, or

(b) that in relation to the volume of its business the Company now has more capital sunk in Stock-in-Trade, Work in Progress, and Book Debts than was the case five years previously. This may either be due to circumstances over which the Company has no control, or it may be due to mismanagement—that is to say, to the carrying of too heavy a stock, and to the neglect to collect promptly debtors' outstanding accounts.

With respect to Liabilities, it will be observed that the Trade Creditors and Reserves for Outstanding Expenses, while fluctuating from year to year, show no marked trend either in one direction or another. It will, however, be noted that the Creditors, etc., at the date of the last Balance Sheet are substantially higher than at any previous date in the series, and this prompts the enquiry whether the Company pays its Trade Creditors' Accounts promptly when due.

As regards other Liabilities, it will be noticed that in the last three years Loans from Bankers appear for the first time and are increasing, and that in the last two years Bills Payable are in existence. These circumstances, coupled with the fact that during the last two years the Company held no Investments in Stock Exchange Securities (see the Assets side of the Balance Sheet), convey the suggestion that the Company is becoming very short of Floating Capital. The remaining Liability is that in respect of the 6% Mortgage Debentures, which have been in existence throughout the period reviewed and which amount to no less than £100,000. These Debentures, it will be noted, are redeemable in 1935, and in view of the position at the end of 1929

it is difficult to see how, unless the Company accumulates, by means of retaining in its business profits earned instead of distributing them in dividend, adequate funds will be available to redeem this Debenture Debt on maturity.

While dealing with the question of the retention of profits in the business, it will be noted that the undistributed profits at the date of the Balance Sheet have shown, broadly speaking, a decline throughout the period, and that nothing has been added during the six years to the General Reserve Account of £10,000.

To turn now to the Profit and Loss Account, reference has already been made to the fact that the Trading Account balance shows, broadly speaking, a continuous decline, but that, notwithstanding this and notwithstanding the depletion of liquid resources which is apparent when the whole period of six years is considered, the Company has declared in each year the same dividends, namely an interim dividend at the rate of 4% and a final dividend at the rate of 6%, such dividends absorbing in each year no less a sum than £30,000.

It seems evident from a review of the figures that such a high rate of dividend, while possibly warranted in the first two years of the series, was certainly not justified in the last four years.

It is quite clear that unless in the future there is a very marked improvement in the Company's earnings, the payment of any dividend at all would not be warranted.

One question which obviously should be considered is whether the Company is justified in expending any substantial sum on additions or improvements to Buildings, Plant, and Machinery, bearing in mind that the large additions which have been made during the six years, instead of resulting in enhanced profits, have been accompanied by

declining profits. This seems to indicate that this money is not being judiciously expended.

The trend of events over the six years is very clearly demonstrated by taking the average of certain of the figures for the first two years of the series and comparing them with the average of the figures of the last two years.

The book value of the Fixed Capital employed in the business, namely the Land, Buildings, Plant, and Machinery, on the average of the first two years is about £289,000, whereas the book value in the last two years averages about £343,000, an increase of about 20%.

The Floating Capital in the business—namely the Stock-in-Trade, Work in Progress, Book Debts, Payments in Advance, etc.—for the first two years averages about £114,000, and for the last two years averages about £120,000, an increase of about 5%.

In spite, however, of these increases in the Fixed and Floating Capital, the Trading profits, which in the first two years averaged about £60,000, had declined on the average of the last two years to about £49,000, a decrease approaching 20%.

Then as regards liquid resources generally, whereas in the first year of the series the Company had a balance at its Bankers of about £28,000, and Investments in Stock Exchange Securities of about £24,000, in the last year of the series it had no outside Investments whatever, it had a loan from its Bankers of about £16,000, and it owed on Bills Payable Account about £6,000. Further, whereas in 1924 the Debenture redemption date was eleven years ahead, in 1929 it was only six years ahead, and the Company, as already explained, is in a much worse situation in 1929 in regard to the prospect of repaying the Debentures on maturity than was the case in 1924.

NOTES ON THE ACCOUNTS OF COMPANY B

As regards the tangible Fixed Assets, namely the Free-hold Land, Buildings, Plant, and Machinery, it will be observed that the net book value of these—that is to say, the balance remaining each year after adding the new assets acquired during the year and deducting the depreciation written off during such year—shows a slight increase over the period.

The additions to these Fixed Assets, it will be noted, have, except for the first year, been more or less constant. It will further be noted that as regards depreciation written off, the sum charged annually in the last four years is considerably higher than that charged in each of the first two years of the series, which may indicate either that the charges for the first two years were somewhat on the low side, or, alternatively, that the charges for the last four years have been on the liberal side. Considering the cautious financial policy of the Company over the six years, which will be apparent when the Accounts are reviewed as a whole, it seems likely that the second alternative affords the true explanation.

It will be seen that the book value of Goodwill has been regularly written down out of profits to the extent of £5,000 a year, and that at the end of 1929 the item, which at the end of 1924 stood at £30,000, had been reduced to the relatively negligible figure of £5,000. When the Company's earnings as disclosed by the Profit and Loss Accounts are reviewed and are considered in conjunction with the Capital employed, it will be appreciated that the Goodwill of the Company's business must be of very substantial value. Except, therefore, as a measure of financial prudence, there was no obligation on the Company to write down the book value of its Goodwill.

As regards the Floating Assets employed in the business—namely Stock-in-Trade, Work in Progress, Book Debts, Payments in Advance, etc.—it will be seen that these show a tendency, though not a very pronounced one, to rise during the period reviewed. There is nothing unusual in this, bearing in mind that the trading profits of the Company during the period have shown some appreciable expansion.

Investments in Stock Exchange Securities, it will be observed, have been added to during each of the years reviewed, with the result that at the end of the period these Investments appear in the Balance Sheet at the sum of approximately £40,000. The existence of these Investments forms a valuable bulwark in the sense that they could be readily realized in the event of the Company's floating resources being depleted for any special reason, such, for example, as the sustaining of an unexpected trading loss, or the embarking on exceptionally large Capital Expenditure.

As regards Liabilities, it will be observed that the Sundry Creditors and Reserves for Outstanding Expenses have increased somewhat during the period, as, indeed, is not unexpected in view of the fact that the Company's business has noticeably expanded.

The Mortgage Debenture Debt, it will be noted, is subject to reduction by means of a Cumulative Sinking Fund, the result of which has been that at the end of 1929 the Debentures were reduced to the negligible figure of £2,000; and in 1930 they will have disappeared altogether. This adds very considerably to the strength of the Company's position, as the absence of a Debenture Debt enhances a Company's credit and improves its facilities for raising money on temporary loan from its Bankers or permanently from its Shareholders, should the needs of its business demand such a course,

The Company's Free Reserves have, it will be noticed, consistently increased throughout the period. They are represented by the credit balance on the Debenture Redemption Account, by the balance on the General Reserve Account, and by the undistributed balance on Profit and Loss Account. At the end of 1924 the balances on these three Accounts totalled nearly £107,000, while at the end of 1929 they had increased to about £174,000.

It will be appreciated, from what has been said in other parts of this book, that any additions to a General Reserve Account and to the balance on Profit and Loss Account represent an accretion to the Company's Assets—in other words, they provide more Capital for the needs of the Company's business. The increase in the balance on the Debenture Redemption Account, however, does not have this effect, as it represents not an increase in the Company's Assets, but a decrease in the Company's Liabilities—that is to say, a decrease which results from the redemption and cancellation of Debentures in accordance with the terms of the Debenture Sinking Fund.

In addition to the increase in the reserves, as mentioned above, there is also the reserve—which in a sense may be considered a hidden one—which is created by means of writing down the book value of Goodwill. In this connection it will be borne in mind that the fact that £5,000 a year is debited to Profit and Loss Account and credited in reduction of the book value of the Asset 'Goodwill' does not represent any actual outgoing; in other words, there is no real depletion of the Company's Assets. The real position is, therefore, no different than would have been the case had the Goodwill remained in the Balance Sheet throughout the period at the figure of £30,000, and if the sums which, as a matter of fact, have been debited to Profit and Loss Account

and credited in reduction of Goodwill Account had been left at the credit of Profit and Loss Account, in which event, of course, the undistributed balance shown on Profit and Loss Account at the end of the period (which is a Free Reserve) would have been correspondingly higher.

It is now convenient to look at the position of the Company from the point of view of earning capacity and profits available for distribution in dividend.

It will be noticed that, taking the period reviewed as a whole, there has been a noticeable expansion in the amount of the trading profits. Notwithstanding this, however, the Company has wisely limited the dividend to the same rate throughout the period-namely 10%-and this dividend, even in the year exhibiting the lowest profits (namely 1927), has been well within the Company's capacity to pay. As will be seen, the net profits for the first year of the series, namely 1924—that is to say, the profits after providing for Directors' remuneration, depreciation, and after charging the Interest and Sinking Fund instalment on the Debentures amounted to £41,403. The Company distributed, however, less than three-fourths of this amount in dividend, and utilized the bulk of the balance to write down Goodwill and to add to the General Reserve Account, thus strengthening the liquid resources of the business. The appropriations in the subsequent years have been exactly the same, and, further, there has been, broadly speaking, an increasingly large balance carried forward as undistributed on Profit and Loss Account. The needs of the Company's expanding business have necessitated the retention of a certain amount of the profits in the business each year in order to finance the net additions to the Asset of 'Land, Buildings, Plant, etc.,' and also in order to provide for the increasing amount

of Stock-in-Trade, Work in Progress, Book Debts, etc. The Company has, however, as already indicated, gone further than this; it has retained in addition sufficient of its profits to enable Investments in Stock Exchange securities to be accumulated, amounting at the end of 1929 to about £40,000.

The Company seems to be reaching a position of such strength as, in the course of a year or two, would justify a material increase in the rate of dividend. It will be observed that in 1930 there will be a negligible charge in respect of the Debenture Service (namely the Interest and Sinking Fund), and that in 1931 this charge will have disappeared altogether. As compared, therefore, with the position in 1929, the Company's Profit and Loss Account will benefit to the extent of £8,000.

Then, as regards the writing down of Goodwill, if the Company follows in 1930 the course which it has adopted throughout the period reviewed, it will have written its goodwill out of its books entirely; consequently there can be no further appropriation of profits under that head.

Any retention of future profits in the business over and above the amount necessary to finance the net additions to Fixed and Floating Assets employed in the business will presumably result in additions to the Investments in Stock Exchange securities; and it will be a matter of policy for the Directors to consider whether any upper limit should be placed, either upon the additions made each year to the Investments in Stock Exchange securities or to the total of such Investments. When such limit or limits have been reached, the Company would be in a position to distribute in dividend the whole of its annual profits.

Another matter to which the Directors might then give consideration would be the advisability of making, out of the

balance on General Reserve Account, an issue of bonus shares to the Shareholders. By enlarging the Issued Share Capital by such means, they could distribute a larger sum in dividend each year but still retain the same percentage rate of dividend as previously.

APPENDIX 3

'PRO FORMA' PROSPECTUS

A copy of this Prospectus has been filed with the Registrar of Joint Stock Companies

Application will be made to the Committee of the Stock Exchange, London, for permission to deal in the Preference Shares, and in due course for an official quotation.

The Subscription List will open on Tuesday, 7th January, 5, and will close on or before Thursday, 9th January, 1930.

WALTER BULLERFIELD & COMPANY LIMITED (Incorporated under the Companies Act, 1929)

SHARE CAPITAL £1,250,000 Divided into

| 7% Cumulative Preference Shar | res | Authorised | Issued and to be issued |
|-------------------------------|-----|--------------------|-------------------------------|
| of £1 each | ••• | 500,000 750,000 | 400,000 600,000 |

£1,250,000 £1,000,000

The Cumulative Preference Shares confer the right to a fixed Cumulative Preferential Dividend at the rate of 7% per annum on the Capital at the time being paid up thereon, and the right in a winding-up to repayment of Capital and arrears of Dividend, whether declared or earned or not, down to the date of such repayment, in priority to the Ordinary Shares, but do not confer any further right to participate in profits or assets.

The Articles of Association provide that the Cumulative Preference Shares do not confer upon the holders thereof the right to have notice of or to attend or vote at any General Meeting of the Company unless:

- (a) The meeting is convened for the purpose of passing a resolution to wind up the Company or for altering the Articles of Association of the Company in any manner directly affecting the rights and privileges attaching to such Shares; or
- (b) The fixed Cumulative Dividend on such Shares shall be in arrear for more than twelve months, and then so long only as the same shall thereafter remain unpaid, but that, subject to the foregoing, on a show of hands every member present in person has one vote, and on a poll every member present in person or by proxy has one vote for each Share of which he is the holder.

No Mortgages or Debenture charges (other than the usual Bankers' and other like charges on goods and mercantile documents) can be created on the Company's properties without the prior consent of the Cumulative Preference Shareholders by Extraordinary Resolution passed at a separate General Meeting of such Shareholders.

ISSUE OF

400,000 7% CUMULATIVE PREFERENCE SHARES OF £1 EACH AT PAR

THE X.Y.Z. FINANCE COMPANY, LIMITED, of 37 North Street, London, E.C.,

has been authorized by the Company to receive applications for the above 400,000 7% Cumulative Preference Shares, through

THE BLANK BANK LIMITED, 100 Lombard Street, London, E.C.3 (and all branches),

at the price of 20s. per Share, payable as follows:

| | | 20 | o | ,, ,, | |
|-------------------------|-----|----|------------|-----------|---|
| On the 30th April, 1930 | • • | 10 | 0 | ,, ,, | |
| On allotment | | 7 | 6 | ,, ,, | |
| On application | | | <i>d</i> . | per Share | e |

Payment in full may be made on Allotment, provided that such payment is received on or before the 18th January, 1930.

Interest at the rate of 4% per annum will be allowed on such pre-payment.

DIRECTORS

(Here would follow the names and descriptions and addresses of the members of the Company's Board.)

BANKERS

(Here would follow the names and addresses of the Company's Bankers.)

BROKERS

(Here would follow the names and addresses of the Company's Stockbrokers.)

SOLICITORS

(Here would follow the name and address of the Company's Solicitors.)

Auditors

(Here would follow the name and address of the Company's Auditors.)

Secretary and Registered Office (Here would follow the appropriate information under the above head.)

OBJECTS.—The Company has been formed for the purposes specified in its Memorandum of Association, and in particular to acquire and take over as a going concern the Engineering business hitherto carried on by the firm of Walter Bullerfield & Company, of Blank Street, Sheffield, which firm has been in existence for some thirty years.

ASSETS.—The Freehold and Leasehold Properties and the Fixed Plant, Machinery, Fixtures, etc., have been valued by Messrs. G. H. & Sons, of 2 London Road, Manchester, on the instructions of the Vendors, and their report is appended:

2, London Road, Manchester. 2nd December, 1929.

To the Directors of Walter Bullerfield & Co. Ltd.

GENTLEMEN,

In accordance with instructions received, we have inspected the Freehold and Leasehold Properties and the

Fixed Plant, Machinery, Fixtures, etc., to be acquired by your Company from Messrs. Walter Bullerfield & Company. These Properties comprise:

[Here would follow details of the Assets in question.]

We value the foregoing as a going concern (exclusive of Goodwill) as at the 30th September, 1929, at the sum of £501,486. This valuation does not include any Stock-in-Trade or Work in Progress.

We are,

Freshold and Lassahald Draman

Yours faithfully, (Sgd.) G. H. & Sons.

The aggregate net value as at the 30th September, 1929, of the Assets to be acquired from Walter Bullerfield & Company by Walter Bullerfield & Co. Ltd., was as follows:

| Freehold and Leasehold Proper- | | |
|--|----------|----------|
| ties, Fixed Plant, Machinery, Fixtures, | | |
| etc. (as valued by Messrs. G. H. & Sons) | | £501,486 |
| Stock-in-Trade and Work in Pro- | | |
| gress (as certified by the Vendor firm | | |
| to be at or under cost) | | 159,397 |
| Book Debts, Cash, etc. (as guar- | | |
| anteed by the Vendor firm) | £169,280 | |
| Less: Floating Liabilities guaran- | | |
| teed by the Vendor firm not to exceed | 19,460 | |
| | | |

Goodwill 89,297

£900,000

Purchase Consideration.—The consideration payable by the Company for the above Assets is £900,000—to be satisfied by the payment of £300,000 in cash and by the allotment to the Vendor firm of 600,000 Ordinary Shares

of £1 each, credited as fully paid. The Vendor firm, out of the Cash consideration, are discharging Bank and other loans to the extent of approximately £220,000. The Company is to be entitled to the profits of the business as from the 1st October, 1929. The cash portion of the Purchase Consideration carries interest in favour of the Vendors at the rate of 5% per annum from the 1st October, 1929, and the Ordinary Shares to be allotted to the Vendors rank for Dividend from the same date.

Profits.—The following certificate has been received from Messrs. E. F. & Co., Chartered Accountants:

I, Broad Street, London, E.C. 18th December, 1929.

To the Directors of
Walter Bullerfield & Co. Ltd.
Gentlemen,

In accordance with instructions received, we have examined the books and accounts of the firm of Walter Bullerfield & Company, Blank Street, Sheffield, for the five financial years ended the 30th September, 1929, and we certify that the profits of the firm, after making such adjustments as are, in our opinion, appropriate, before charging interest on Capital and borrowed money (to be repaid by Vendor out of cash Purchase Consideration), Income Tax and the remuneration of Partners, but after charging in respect of depreciation of Properties, Plant, etc., such sums as, in the opinion of the Valuers, Messrs. G. H. & Sons, are adequate, are as follows:

| Year to | 30th Sep | tember, | 1925 | | | £100,83 6 |
|---------|----------|---------|------|-----|-----|----------------------|
| ,, | ,, | ,, | 1926 | • • | • • | 84,372 |
| ,, | ,, | ,, | 1927 | | | 101,397 |

| APPENDIX J 277 |
|--|
| Year to 30th September, 1928 £106,483 |
| " " " 1929 109,874 We are, gentlemen, Yours faithfully, (Sgd.) E. F. & Co. |
| As will be seen from the foregoing certificate, the profits of the Vendor firm have shown a continuous increase over |
| the last five years, except as regards the year in which the |
| Coal Stoppage occurred—namely the year to 30th Sept- |
| ember, 1926. |
| The average profits of the last three years of |
| the series amount to $\dots \dots \dots$ |
| From this sum requires to be deducted a |
| charge for Directors' fees and Managing Direc- |
| tor's remuneration in accordance with the Com- |
| pany's Articles of Association, and as provided in |
| the agreements hereinafter referred to, totalling 10,500 |
| The december of the Control |
| Leaving a balance of profit of g |
| The fixed dividend of $7\frac{0}{10}$ on the Cumulative |
| Preference Shares now being issued amounts to 28,000 |
| Leaving a balance available for Dividend on |

Leaving a balance available for Dividend on the Ordinary Share Capital and for appropriations to General Reserves of £67,418

which balance is equivalent to over 11% on the issued Ordinary Share Capital of £600,000.

It will be noted that on the basis of the foregoing profits the amount required to meet the annual fixed Dividend on the Cumulative Preference Shares is covered more than three times over.

WORKING CAPITAL.—It is estimated that, after payment of the cash portion of the Purchase Consideration and the

Preliminary Expenses, there will remain out of the proceeds of the present issue a sum of approximately £50,000, which the Directors consider will be adequate to cover additional Working Capital and to meet extensions to existing Plant which are in contemplation.

Management.—The services as Managing Directors of the Partners in the Vendor firm, namely Messrs. Q. R. and S. T., have been secured for a period of seven years with a view to preserving continuity of management.

PRELIMINARY EXPENSES.—The Preliminary Expenses of the Company (inclusive of duty on the Share Capital and Stamp Duty incidental to the transfer of Assets to the Company, and underwriting and overriding commissions) are estimated at £48,000, and are payable by the Company.

Underwriting.—Under the contract mentioned below, the X.Y.Z. Finance Co. Ltd. has agreed to guarantee the subscription of the 400,000 7% Cumulative Preference Shares now offered, for an underwriting commission of $2\frac{1}{2}$ % and an overriding commission of one-half of 1%, making 3% in all. Various sub-underwriting contracts have been entered into, to which the Company is not a party.

A copy of the Memorandum of Association of the Company is printed overleaf, and forms part of this Prospectus.

Brokerage.—A Brokerage of 3d. per Share will be paid on Shares allotted to the public in respect of applications bearing the stamp of a Broker, Banker, or other approved Agent.

DIRECTORS' REMUNERATION AND QUALIFICATION.—The Company's Articles of Association provide (inter alia) as follows:

(Here would follow quotations from the appropriate clauses in the Company's Articles of Association dealing

with the remuneration of Directors and the Shareholding necessary to qualify a Director.)

SUMMARY OF CONTRACTS ENTERED INTO

(Note—The Companies Act requires the Prospectus to state the dates of, and the parties to, every material contract, not being a contract entered into in the ordinary course of business carried on or intended to be carried on by the Company or a contract entered into more than two years before the date of issue of the Prospectus, and a reasonable time and place at which any such material contract or a copy thereof may be inspected. There would consequently appear here a brief summary of the various contracts which would fall under the above head. These would include the contract with the Vendors for the purchase of the business, the contract with the X.Y.Z. Finance Company in reference to the underwriting and making the issue, and the contracts with the Vendors in respect of their services as Managing Directors.)

Interests of Directors

(Note—The Companies Act requires the Prospectus to state full particulars of the nature and extent of the interest, if any, of every Director in the promotion of or in the properties proposed to be acquired by the Company, or, where the interest of such Director consists of being a Partner in the firm, the nature and extent of the interest of the firm. The Prospectus must also contain a statement of all sums paid, or agreed to be paid, to any Director (or to the firm of which he is a member) in cash, or Shares, or otherwise, by any person either to induce him to become, or to qualify him as, a Director or otherwise for services rendered by him (or by the firm) in connection with the promotion or formation of the Company.)

Particulars Concerning Vendors

(Note—The Companies Act requires the Prospectus to state the names and addresses of the Vendors, and the amounts payable in cash, Shares, or Debentures to each Vendor.)

Applications for Shares should be made on the accompanying form, and sent with a remittance for the amount to The Blank Bank Ltd., 100 Lombard Street, London, E.C. 3, or any of its branches.

If no allotment is made the application money will be returned in full, and where the number of Shares allotted is less than the number applied for, the balance of the application money will be applied towards the amount payable on allotment, and the surplus (if any) will be returned to the applicant. Failure to pay the amount due on allotment, or the subsequent instalments on the due dates, will render the amounts previously paid liable to forfeiture, and the allotment to cancellation.

Interest at the rate of 8% per annum will be charged on any instalment which may be accepted after its due date.

Share Certificates will be ready for delivery on and after the 5th June, 1930, in exchange for fully paid allotment letters.

A print of the Memorandum and Articles of Association of the Company, and copies of the before-mentioned contracts, Valuers' valuation and Accountants' certificate can be inspected at the offices of Messrs. Dash & Blank, Solicitors, 5 Coleman Street, London, E.C., during business hours while the list is open.

Dated the 2nd January, 1930.

General Note.—It is not claimed that the above pro forma Prospectus is in any way complete, or that it is in all respects in a form which would be found in practice. As will be evident from its perusal, much detailed information has been omitted. The Prospectus has been drafted merely with the object of giving prominence to the chief financial features which are usually to be found in such documents and which are of special interest to the prospective investor.

In order to make the financial transactions referred to in this Prospectus clear to the reader, there is appended:

- (a) A summary of the cash receipts and payments in connection with the issue,
- (b) A pro forma Balance Sheet immediately after the issue has taken place. In regard to this pro forma Balance Sheet, it will be appreciated that in practice the figures would be somewhat different, as by the time that the last calls on the Shares had been received other transactions would have taken place—i.e. those in connection with the carrying on of the business owned by the new Company. The Balance Sheet is drafted on the basis that the whole of the £400,000 in respect of the Preference Share issue was received simultaneously from the public; that out of it was immediately disbursed all the expenses incidental to the public issue, and that the Vendor was at the same moment paid the whole of the consideration due to him—i.e. both that payable in cash and that payable in Shares.

'PRO FORMA' STATEMENT OF CASH RECEIPTS AND PAYMENTS

| The gross proceeds of the Pre | eference Sl | are issue, namely |
|--|-------------|---------------------------|
| the subscription at par for 400,0 | oo Shares | of \pounds reach, would |
| amount to | | £400,000 |
| The expenses incidental to | | |
| the issue are, let it be pre- | | |
| sumed, as follows: | | |
| Duty on Share Capital | €12,500 | |
| Stamp Duty on conveyance | | |
| of Assets from the Vendor | | |
| firm to the new Company | 7,086 | |
| Underwriting and overrid- | | |
| ing commission payable | | |
| to the X.Y.Z. Finance | | |
| Company for underwrit- | | |
| ing the 400,000 Shares is- | | |
| sued, being at the rate of | | |
| 3% | 12,000 | |
| Cost of advertising, print- | | |
| ing, and circulating the | | |
| Prospectus, and expenses | | |
| in connection with | | |
| the receipt of the appli- | | |
| cations and the issue of | | |
| the allotment letters | 7,247 | |
| Valuers' fees for valuing | | |
| Company's properties, Accountants' fees for cer- | | |
| tifying the profits, Solici- | | |
| tors' charges, including | | |
| Carried forward | Co2 200 | £,400,000 |
| Guirica joiwara | £30,033 | £400,000 |

| | J | 3 |
|--|---------|---------------------------|
| Brought forward the costs of preparing the various agreements and of preparing and printing the Company's Memor- andum and Articles of | £38,833 | £400,000 |
| Association Brokerage (at the rate of 3d. a Share) paid on Shares allotted to the public in respect of applications bearing the Stamp of a Broker, Banker, or other | 6,560 | |
| approved Agent Sundry other charges not falling under any of the | 2,560 | |
| foregoing heads | 832 | |
| Cash paid to Vendor firm, being the cash portion of the Purchase Consideration in accordance with the agreement | | 48,78 <u>5</u> 300,000 |
| Balance available to the new Company for additional Working Capital, and for extensions to Plant, etc., as mentioned in the Prospectus | | £51,215 |

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| 7% Cumulative Preference Share Capital, fully paid, issued to the public £400,000 Ordinary Share Capital, fully paid, issued to the Vendor firm as part consideration for the purchase of their business 600,000 Floating Liabilities taken over from the Vendor | Freehold and Leasehold Properties, Plant, Ma- chinery, Fixtures, etc., acquired from the Vendor firm£501,486 Stock-in-Trade and Work in Progress acquired from the Vendor firm Book Debts, Cash, etc., acquired from the Ven- dor firm169,280 Goodwill, at amount at- |
|--|---|
| firm as stated in the Prospectus 19,460 | tributed to it under the purchase agreement 89,297 Cash—available for further working Capital and |
| | for extensions to Plant 51,215 Preliminary Expenses . 48,785 |

In connection with the underwriting of public issues the expressions 'overriding commission' and 'firm underwriting' not infrequently appear, and explanation of these terms therefore appears called for.

£,1,019,460

£,1,019,460

The underwriting contract in respect of an issue of securities is often made with one Finance House, and that Finance House places a number of sub-underwriting contracts. The sub-underwriters would be responsible to the Finance House, and the Finance House would be responsible to the parties by whom the Prospectus was issued. The latter would pay a certain underwriting commission to the Finance House, say at the rate of 3%. Of this, say $2\frac{1}{2}\%$ would be paid to the sub-underwriters, and the balance, namely one-half of 1%, would go to the Finance House for its responsibility in the matter. The latter payment is known as an 'overriding commission.'

'Firm underwriting' means that the parties in question definitely take up the securities and receive a commission for so doing. For example, an issue may be made for £150,000, and the Prospectus may state that of this amount £50,000 has been underwritten 'firm' for a commission of $2\frac{1}{2}\%$. There will therefore only be a balance of £100,000 for which the public can apply.

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